TRANSFER PRICING METHODS

An Applications Guide
Transfer Pricing
Methods
Robert Feinschreiber is a practicing attorney and counselor in Key Biscayne, Florida, and had been a CPA. As a partner in the firm of Feinschreiber & Associates, his transfer pricing clients over the past 30 years include foreign-owned U.S. corporations, U.S.-based multinationals, and U.S. exporters. Much of Mr. Feinschreiber’s transfer pricing practice addresses transfer pricing disputes and audit response, global structuring, and litigation.

Mr. Feinschreiber is an expert witness. He was quoted as an authority by the Tax Court, as well as by Business Week and Forbes. Mr. Feinschreiber has been a consultant to several foreign governments.

Mr. Feinschreiber has addressed a wide spectrum of transfer pricing issues, which include:

- Licensing ownership
- Licensing valuation
- Cost analysis
- SIC evaluation
- Contemporaneous documentation
- Joint product vs. by-product transfer pricing
- Export transfer pricing incentives
- Excess capacity determination in transfer pricing
- Advance pricing agreements
- Life cycle implications of transfer pricing
- Gray market considerations
- Customs–transfer pricing interrelationship
- Antitrust–Hart-Scott-Rodino transfer pricing applications

The U.S. Treasury and the Internal Revenue Service (IRS) selected Robert Feinschreiber to examine the impact of the IRS’s transfer pricing program after 10 years from promulgation of the transfer pricing regulations. Mr. Feinschreiber undertook this study beginning in 2001 and ending in 2003.

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## Preface

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Transfer Pricing Methods: An Applications Guide is specifically designed to assist midsized businesses facing transfer pricing issues, whether now or in the future. Transfer Pricing Methods is divided into five parts:

Part One: Understanding Transfer Pricing
Part Two: Applying Specific Transfer Pricing Techniques
Part Three: Focus on International Transfer Pricing Issues
Part Four: Avoiding Transfer Pricing Penalties
Part Five: Advanced Transfer Pricing Issues

We address business issues and general principles tax and guidelines in Part One. We do so with midsized businesses specifically in mind. Governments designed transfer pricing regulations with large multinational corporations in mind, but they failed to exempt midsized businesses from their scope. These transfer pricing regulations, as implemented, can overwhelm the midsized business’s capacity to create and retain viable information. With this issue clearly in mind, we endeavor to provide midsized businesses with practical transfer pricing advice.

Transfer pricing is complex because variations in business circumstances dictate transfer pricing methods. Part Two examines the specifics of each transfer pricing method. The selection of the transfer pricing method is often an area of dispute, as is the basic data that would apply in each instance. We begin with the comparable uncontrolled cost method, the resale method, and the cost plus method. We then turn our attention to the popular but often misapplied comparable profits method. Later, we address the comparable uncontrolled transaction method for intangibles and transfer pricing for services. Then we address cost sharing and profit split alternatives.

In Part Three we turn our attention to international and foreign issues. We begin with the impact of the foreign-owned U.S. corporation provisions that often serve as a backstop to transfer pricing regulations. Then we turn our attention to the transfer pricing regulations issued by the Organisation for Economic Cooperation and Development. Finally, we turn our attention to the transaction net margin method, which is not an acceptable transfer pricing method in the United States but generally applies elsewhere.
Taxpayers can be subject to penalties for transfer pricing errors or just for bad guesswork. Part Four discusses these penalties and potential escapes from these penalties. Then we examine the transfer pricing penalty for contemporaneous documentation infractions.

Finally, we address advanced transfer pricing topics, including, for example, the ownership of intangibles, cost analysis, life cycle issues, and antitrust considerations.

I am pleased that John Wiley & Sons, Inc. selected me to be the editor of *Transfer Pricing Methods: An Applications Guide*, whether this selection is based on my practical transfer pricing experience as a practitioner during the past 30 years or because of the advice I provided to the U.S. Treasury and the IRS. I am grateful to Sheck Cho at John Wiley & Sons, Inc. for developing the transfer pricing trilogy, bringing the first edition of the *Transfer Pricing Handbook* to fruition, developing the supplements, and encouraging me to develop the second edition, and more recently the third edition. Furthermore, I am grateful to him for helping me develop the companion volume, *International Transfer Pricing: A Country-by-Country Guide*.

In addition, I have a debt of gratitude to Natu Patel, the principal tax official at John Wiley & Sons, Inc. for encouraging me to undertake this project as well as to Tim Burgard and Stacey Rympa at John Wiley & Sons, Inc., who worked with me on the specifics of the transfer pricing trilogy.

We will be continuing the supplement process. Readers are welcome to contact me to suggest additional topics or suggestions or to inform me about transfer pricing planning or audit experiences and litigation techniques. I can be reached at Feinschreiber & Associates, 1121 Crandon Boulevard, Key Biscayne, FL 33149, telephone 305-361-5800, e-mail: multijur@aol.com.

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Key Biscayne, Florida
December 2003
Understanding Transfer Pricing
Transfer pricing, for tax purposes, is the pricing of intercompany transactions that take place between affiliated businesses. The transfer pricing process determines the amount of income that each party earns from that transaction. Taxpayers and the taxing authorities focus exclusively on related-party transactions, which are termed controlled transactions, and have no direct impact on independent-party transactions, which are termed uncontrolled transactions. Transactions, in this context, are determined broadly, and include sales, licensing, leasing, services, and interest.

The concept of an international corporate headquarters of a multinational corporation that uses transfer pricing to minimize worldwide taxation is no longer viable. Two impediments limit the use of transfer pricing to achieve tax minimization: (1) the tax authorities are intent on their own revenue maximization by thwarting the taxpayer’s tax minimization plans, and (2) nontax considerations may be more significant in taxation than taxation.

COMPARISON OR DIVISION

Section 482 of the Internal Revenue Code (IRC) was finalized in July 1994. Section 482 provides two approaches to transfer pricing:

1. Dividing the total income from the transaction between related parties
2. Comparing controlled transactions with uncontrolled transactions

Of the two methods set forth, these regulations prefer that transfer pricing be based on the comparison of transactions method rather than the division of income approach.

1 (TD 8552) 59 FR 34971 (July 8, 1994).
RELATIONSHIP OF THE PARTIES

The relationship between parties to a transaction affects the way in which transfer pricing is determined. The transfer pricing regulations recognize three relationships:

1. Both parties to the transaction are controlled, as in a sale between a U.S. subsidiary and a foreign subsidiary of the parent company.
2. One party to the transaction is controlled, the other party is uncontrolled, as in a sale between a U.S. subsidiary of a parent company and an unaffiliated company.
3. Neither party is controlled, as when the transaction is wholly independent from the taxpayer’s activities.

The transfer pricing regulations suggest that a taxpayer compare its totally controlled transactions with transactions between a controlled party and an uncontrolled party. The regulations generally do not favor the comparison of wholly independent transactions to determine price. The primary thrust of the transfer pricing regulations is a comparison between wholly controlled transactions with transactions between a controlled party and uncontrolled parties, which are often referred to as in-house comparables.2

OVERVIEW OF THE TAX CHANGES

The regulations fundamentally change the way in which the taxpayer and the IRS determine transfer pricing. Before the regulations came into effect, the IRS could challenge a taxpayer’s transfer price as not arm’s length, and the IRS could then assert a specific transfer price that it believed was arm’s length. The IRS was frequently defeated in court when it challenged the taxpayer and asserted its own transfer pricing method. Faced with prior IRS defeats, the regulations permit the taxpayer to use a range of transfer prices but expect the taxpayer to develop its transfer pricing methodology in advance.3

The IRS will accept the taxpayer’s transfer pricing as arm’s length if the price is within a range of arm’s-length prices; however, the taxpayer should not expect much solace from the IRS. The IRS now may be able to move the range of acceptable prices or truncate the transfer pricing range. Moreover, the taxpayer’s pricing decisions could be subject to an extensive penalty regime. A taxpayer that chooses the inappropriate transfer pricing method is subject to penalties, but a taxpayer can avoid sanctions if it prepares contemporaneous documentation that substantiates its transfer pricing methodology.4

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3 Preamble to the 1994 transfer pricing regulations.
4 Treas. Reg. § 1.6662-6(d)(2)(iii).
Under the prior transfer pricing regulations, taxpayers were not required to substantiate their transfer pricing decisions, whether at the time the tax return was filed or during the prior taxable year. The taxpayer merely second guessed the IRS’s adjustments if they were proposed. The order is now reversed: First the taxpayer must substantiate its pricing, and then the IRS can challenge the taxpayer’s approach. Once the taxpayer is locked in to its transfer pricing method, it is precluded from challenging the IRS’s approach by suggesting a different method. The taxpayer, forced to select a transfer pricing method before the transaction, is analogous to a person who must attempt to hit a moving target while blindfolded.

**APPROACHES TO TRANSFER PRICING**

Taxation that is based on transfer pricing is becoming an important issue for many companies, whether U.S. based or foreign based. The regulations have sought to impose extensive general principles and guidelines that apply when the taxpayer selects the transfer pricing method. These methods impose penalties on an inappropriate choice of a transfer pricing method. In addition, the administrative cost of complying with the regulations can be extensive. As a result, implementation of the transfer pricing regulations may impose significant costs on the taxpayer above and beyond the taxes themselves.

Faced with this transfer pricing onslaught, businesses have chosen different approaches to the tax aspects of transfer pricing. At the outset, the selection of a transfer pricing strategy is determined by three factors:

1. Taxes imposed on the transfer pricing decision
2. Administrative time and expense incurred
3. Potential penalties (which are discussed next)

**PENALTIES**

The presence or absence of a potential penalty may determine a taxpayer’s transfer pricing policy. If the effective tax rates in both jurisdictions are equal, including withholding tax, and there are no impediments to obtaining the foreign tax credit, the multijurisdictional taxpayer might have no tax incentive to adjust transfer pricing apart from the risk of IRS penalties. Nontax factors, such as tariffs and unemployment compensation, may determine transfer pricing policy but are not discussed here.

Two types of penalties can be imposed on transfer pricing adjustments:

1. Substantial valuation misstatement
2. Gross valuation misstatement

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5 Treas. Reg. § 1.482-1(a)(1).
6 Treas. Reg. § 1.6662-6(b).
The two penalties are of the same type but differ in magnitude. The substantial valuation misstatement penalty is 20 percent of the tax; the gross valuation misstatement penalty is 40 percent of the tax. Regardless of the magnitude of the misstatement, there are two types of penalty:

1. Transactional
2. Net 482 adjustment

There are four types of transfer pricing penalties:

1. Transactional penalty: substantial valuation misstatement
2. Transactional penalty: gross valuation misstatement
3. Net 482 adjustment: substantial valuation misstatement
4. Net 482 adjustment: gross valuation misstatement

**Transactional Penalty**

A *substantial valuation misstatement* penalty applies to a taxpayer who uses unnecessarily high or low valuations. A *gross valuation misstatement* penalty applies to a taxpayer who uses more extreme low valuations or more extreme high valuations.

**High Valuation—Substantial Valuation Misstatement** The substantial valuation misstatement penalty applies if the price paid for “any property or services (or for the use of property),” as claimed by the taxpayer on the tax return, is 200 percent or more of the “amount determined under Section 482 to be the correct price.” For example, a taxpayer charges Affiliate A $4,000 for services. It is determined that “the correct price” is $1,800. The substantial valuation misstatement penalty applies.

**Low Valuation—Substantial Valuation Misstatement** The substantial valuation misstatement penalty applies if the price paid for “any property or services (or for the use of property),” as claimed by the taxpayer on the tax return, is 50 percent or less of the “amount determined under Section 482 to be the correct price.” For example, a taxpayer charges Affiliate B $4,000 for services. It is determined that “the correct price” is $8,200. The substantial valuation misstatement penalty applies.

**High Valuation—Gross Valuation Misstatement** The gross valuation misstatement penalty applies if the price paid for “any property or services (or for the use of property),” as claimed by the taxpayer on the tax return, is 400 percent or more of the “amount determined under Section 482 to be the correct price.” For example, a taxpayer charges Affiliate C $4,000 for services. It is determined that “the correct price” is $800. The gross valuation misstatement penalty applies.

**Low Valuation—Gross Valuation Misstatement** The gross valuation misstatement penalty applies if the price paid for “any property or services (or for the use of property),” as claimed by the taxpayer on the tax return, is 25 percent or less of the “amount determined under Section 482 to be the correct price.” For example, a tax-
payer charges Affiliate D $4,000 for services. It is determined that “the correct price” is $16,200. The gross valuation misstatement penalty applies.

Net Adjustment Penalty

The net adjustment penalty is based on “net Section 482 adjustments,” which are the sum of all increases in taxable income less any decreases in taxable income. Increases are counted to determine the net adjustment if they result “from allocations under Section 482.” Decreases are counted to determine the net adjustment if the decreases are attributable collateral adjustments. Thus it is contemplated that positive adjustments will exceed negative adjustments by a wide margin.

Substantial Valuation Adjustment  A substantial valuation penalty applies if a net 482 adjustment exceeds either of two thresholds:

1. $5 million
2. 10 percent of gross receipts

The lower of the two amounts determines whether the substantial valuation penalty applies. If a company has gross receipts of less than $50 million, the threshold is 10 percent of gross receipts. If the company has gross receipts of $50 million or more, the threshold is $5 million. For example, Company X has gross receipts of $40 million. A Section 482 adjustment was 4.5 million, for example, income of $1.5 was adjusted to $6 million. The adjustment of $4.5 million exceeds 10 percent of gross receipts or $4 million, so the substantial valuation misstatement penalty applies.

Gross Valuation Misstatement  A gross valuation misstatement penalty applies if a net 482 adjustment exceeds either of two thresholds:

1. $20 million
2. 20 percent of gross receipts

The lower of the two amounts determines whether the gross valuation misstatement penalty applies. If a company has gross receipts of less than $100 million, the threshold is 20 percent of gross receipts. If a company has gross receipts of $100 million or more, the threshold is $20 million. For example, Company Y has gross receipts of $80 million. A Section 482 adjustment was $17 million; for example, income of $3 million was adjusted to $20 million. The adjustment of $17 million exceeds 20 percent of gross receipts or $16 million, so the gross valuation misstatement penalty applies.

Avoiding the Penalty

The transfer pricing penalty can be avoided in limited circumstances. The regulations specify two methods:

7 Treas. Reg. § 1.6662-6(b).
8 Treas. Reg. § 1.6662-6(d)(1).
1. By demonstrating reasonable cause and good faith, but only as to the transac-
tional penalty
2. By complying with the specific method requirement and the documentation 
requirement

TRANSFER PRICING STRATEGIES

Many transfer pricing strategies are available. Before you dwell on the morass of new 
transfer pricing tax rules in depth, it might be advantageous for you to assess where 
your company fits, or should fit, in the spectrum of strategies.

Head in the Sand Approach

One approach to transfer pricing is to do nothing, stand pat. As one taxpayer stated, 
“We have some sand, and we’re looking for an ostrich. We don’t understand the tax 
rules, and neither does the IRS. We don’t want to rock the boat, or provide the IRS 
with a roadmap to our company with the documentation we prepare. The preamble 
to the new transfer pricing regulations says that the ‘estimated average annual 
burden per recordkeeper is 0.8 hours,’ and we will be devoting just that amount, 48 
minutes per year, to transfer pricing.”

Comprehensive Analysis Approach

Some companies are implementing a full-blown comprehensive approach to transfer 
pricing, creating and developing a team of decision makers and other resource 
people, both within and without the company itself. More than 30 categories of pro-
fessionals could be included in the transfer pricing team, including the following:

- **Accountants**
  - *Accounts payable accountants.* To review credit and collection strategies, a 
    process needed to compare transactions
  - *Controllers.* Operations executives providing the database to develop and 
    defend transfer pricing
  - *Cost accountants.* To develop the bulwark of the database needed to apply the 
    resale price method or the cost plus method
  - *Financial accountants.* Using FAS and SEC accounting rules to prepare a data-
    base needed for comparative purposes
  - *Tax accountants.* To prepare the documentation for the tax return

- **Attorneys**
  - *Contract attorneys.* An analysis of contracts and terms is mandatory for trans-
    fer pricing purposes.
  - *Customs attorneys.* The cost of tariffs and tax costs should be considered 
    together for transfer pricing purposes.
Practical Aspects of Transfer Pricing

- Intellectual property attorneys. Ascertaining the scope of intangible property may be significant; licensing is an important facet of transfer pricing.
- Litigation attorneys. Discovery procedures and confidentiality are needed long before litigation is contemplated.
- Tax attorneys. Interface between the other attorneys and the accountants
- Trade attorneys. Countervailing duties and dumping should be considered together with taxation.

- Computer programmers. To implement record retention and prepare analytical reports
- Customs specialists. Customs documentation is important evidence for tax purposes.

Economists

- Economic geographers. To prepare analysis between countries, sometimes needed for comparative purposes
- Microeconomists. Difference analysis is at the heart of transfer pricing analysis, preparing the viability of comparable transactions.
- Macroeconomists. To select the database; to cope with business cycles as they affect transfer pricing

- Employee benefits specialists. Fringe benefits might affect costing to determine the gross profit markup or gross profit.

Engineers

- Engineering economists. To interface between production engineers and process engineers and economists
- Production engineers. To determine functions of the company
- Process engineers. To determine functional analysis

Financial analysts. To review financial reporting prepared by the company’s competitors, to determine comparable ratios

- Industry specialists. Persons who know what is going on in the industry, developing market share analysis
- Marketing specialists. To assess the advertising, marketing, and sales functions of the company
- Mathematical statisticians. To determine the relevant range of transactions for comparability analysis
- Personnel. To obtain job descriptions needed to determine functions performed
- Operational analysts. Developing procedures that explain how the company works
- Risk analysts. To prepare the mandatory analysis of risk and exposure
- Tax specialists

- International tax specialists. Interrelationship with foreign tax credit, allocation and apportionment procedures, foreign sales corporation, foreign reporting procedures in the United States, reporting of income to foreign jurisdictions
■ **State tax specialists.** States can impose transfer pricing rules; coordination of federal and state rules may be needed.

■ **Foreign tax specialists.** Foreign taxes are essential to the overall transfer pricing equation.

■ **Treasurer.** Prepare international currency and hedging analysis, which is required under the tax rules.

### PARAMETERS TO SUBSTANTIATING TRANSFER PRICING

Your company might not fit into either of the two extremes of the head in the sand approach or the comprehensive analysis approach. The approach of one size fits all does not appear to be viable for the tax facets of transfer pricing. Instead, your company’s approach may depend on the size of the business, certain empirical ratios, and other criteria. The following parameters pertaining to business size, profitability, international ratios, and other criteria should be helpful.

#### Business Size

Revenue, income, and assets are factors that could be relevant in assessing the depth and magnitude of your company’s transfer pricing approach, including the following facets:

- Total worldwide sales
- Total worldwide income
- Sales in the United States
- Income from sales in the United States
- Imports to the United States
- Income from imports to the United States
- Intercompany sales—imports and exports
- Income attributable to intercompany sales
- U.S. assets
- Worldwide assets

In general, the higher the magnitude of these numbers, the more likely it is that the company should consider the comprehensive analysis approach. Consider the following:

- The temporary regulations, which are no longer applicable, provided a safe harbor based on $10 million in sales.
- One important penalty applies to adjustments in transfer price of $5 million or more; this penalty could affect a company with revenues of $100 million having profits of $20 million, and having an adjustment of one-quarter of the $20 million profit amount. The penalty issues were discussed previously.
The contemporaneous documentation transfer pricing regulations refer to the tax reporting rules for foreign-owned U.S. corporations. The tax reporting rules have their own size criteria.9

- $50,000, the small amount threshold for reporting an amount on Form 5472
- $5 million, a gross payments threshold that excuses related-party transactions
- $10 million, a U.S. gross receipts threshold that excuses small corporations
- $20 million, a gross receipts threshold that might excuse the taxpayer from the penalty
- $25 million, a gross revenue threshold [U.S.-connected products or services (export and import) of $25 million] that requires the taxpayer to produce data from each significant industry segment
- $100 million, a gross revenue threshold that requires the taxpayer to produce more information, whether or not the segment is significant

**Profitability Ratios**

A company may find it advantageous to devote more effort to establishing and reviewing transfer pricing when a profitability factor or similar ratio is high and to curtail transfer pricing efforts when these factors are low. Here, high profitability might be 15 percent, using the high-profit test within the foreign reporting regulations, which relies on the return on assets. The transfer pricing methods provide for the comparable profits method, and the taxpayer should consider its three methods in deciding upon the level of effort it should undertake. These ratios are the final three of those following:

- Profits divided by sales
- Return on assets
- Rate of return on capital employed
- Operating income divided by sales
- Gross profit divided by operating expenses

**International Ratios**

Transfer pricing audits in the United States are more likely if the foreign portion of total activities is larger. The following ratios should be considered:

- Imports into the United States divided by U.S. sales
- Intercompany sales divided by U.S. sales
- U.S.-connected products or services (export and import) divided by total gross revenue

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Other Criteria

A company could use criteria other than the size of the business, profitability, or international ratios to assess the potential transfer pricing exposure. Additional criteria could include the following:

- **The industry.** Companies that are in industries that are subject to scrutiny by the IRS such as automobiles, electronics, financial services, and others
- **Notoriety.** Companies in which the media would be interested, whether because of the product or service, or because the company has a large number of shareholders or a large number of consumers, or the company has received present or prior publicity
- **Nationality of the company.** Especially companies in which the headquarters are in a country that has a large surplus with the United States
- **Location of subsidiaries.** The presence of tax haven subsidiaries makes the entire operations of the company suspect.
- **Prior tax history.** Including tax adjustments, recurrent U.S. net operating losses

Practical Approaches

Consider the following potential transfer pricing approaches:

- **The international portion of the company’s revenues are below $10 million.** Provide the minimum information to the IRS.
- **The international portion of the company’s revenues are between $10 million and $100 million.** Take a modest approach to protecting the company. John Wiley & Sons, Inc. prepared this book to directly address companies such as these.
- **The international portion of the company’s revenues are $100 million or more.** Consider developing a thorough, comprehensive approach, especially when the company is much larger than $100 million in international sales. John Wiley & Sons, Inc. prepared the *Transfer Pricing Handbook* to directly address companies such as these.
This chapter examines the business facets of transfer pricing. In so doing, we must examine the transfer pricing techniques that apply to intracompany divisions and profit centers as well as to intercompany transfers. To undertake this analysis, we must transcend, but not challenge, the requirements of the transfer pricing regulations.

Intracompany transfer pricing must address such issues as measuring, evaluating, and rewarding the performance of a business segment and its leaders. These performance measures are most often reflected by personnel policies, incentives, bonuses, and the like. These performance issues, which include the aforementioned factors and the components that comprise corporate culture, are not limited to tax saving or to double taxation. In fact, intracompany transfer pricing applies to transfers between corporate divisions and profit centers, and applies even if the divisions or profit centers are located in a single jurisdiction and are devoid of tax issues.

**BASIC DISTINCTIONS**

There is an inherent practical distinction between intercompany transfer pricing and intracompany transfer pricing. The transfer pricing regulations issued by the U.S. Treasury Department (Treasury) and the Organization for Economic Cooperation and Development (OECD) permit a company to select from a number of transfer pricing methods for its intercompany transfers. Companies select their transfer pricing methods from among these enumerated methods, often selecting different methods under different circumstances.

In contrast, companies engaged in production and sale of goods almost invariably use only one method, a cost-based system, for intracompany transfer pricing purposes. Most often, these companies utilize full standard cost transfers or full actual cost transfers, and do so without a profit add-on. Without the constraints imposed by the taxing authorities, many companies decide on an arbitrary intracompany pricing policy that departs from the norms of intercompany transfer pricing tax policy in a number of respects.
Many companies have two pricing regimes: (1) the company employs transfer pricing methods for intracompany transfer pricing purposes and then (2) employs different transfer pricing methods for intercompany transfer pricing purposes. Practical problems then arise as to the coordination of these transfer pricing methods and the availability of the documentation in the context of the transfer pricing penalty contemporaneous documentation rules. The Internal Revenue Service (IRS) may be able to use intracompany information against the taxpayer.

In a number of situations, the goods produced and transferred may be intermediate goods or work-in-process rather than final goods. Intermediate goods by their very nature have no market price, because these goods are not yet marketable. The transfer pricing problem is to measure the cost of production for these intermediate goods.

**SELECTING A PRICING STRATEGY**

A business that is engaged in the process of selecting one or more transfer pricing methods should consider a number of external variables in selecting such a method, whether this decision applies to intercompany transactions or to intracompany transactions. The following are 10 of the most important external variables that affect the selection of a transfer pricing method:

1. U.S. income tax considerations
2. State income and property tax considerations
3. Taxation imposed by a foreign entity
4. Market position, including oligopoly or oligopsony
5. Customs duties and enforcement
6. Inflation or deflation
7. Production capacity, including plant efficiency
8. Currency fluctuation and hedging costs
9. Currency control mechanisms and their effectiveness
10. Relationships with the aforementioned governments

The relative importance of each of these external variables varies between one business and another. Weighing these factors a priori would be counterproductive. Moreover, a business should change the list of variables or the priorities within these variables over time as conditions change.

**DIVISION AND PROFIT CENTER ACCOUNTING**

Before we can address intracompany transfer pricing issues that may be applicable to a particular business, it is important to understand the basics of nomenclature and terminology for such concepts as divisional accounting, cost center, and profit center in the transfer pricing context. For purposes of this analysis, a division is an operating unit that is a principal portion of a corporation in which managers have decision-making authority. A profit center could be a division of a business, but divisions
often encompass many profit centers. *Cost centers* rarely reach the level of constituting divisions. The division or operating unit may encompass more than one legal entity, an issue that the author acknowledges but does not specifically address in this analysis.

**Cost Centers and Profit Centers**

A division or other segment of a business could be either a cost center or a profit center. Let us introduce these two concepts:

1. A *cost center* accumulates costs. Top corporate management normally evaluates a division that is a cost center by focusing on the efficiency of the operation only, such as a reduction in the cost of materials, labor cost savings, operating efficiencies, or other cost saving. Pricing decisions are outside this division’s responsibility.
2. A *profit center* accumulates profit or losses in the accounting sense. In essence, the division is viewed as a mini-corporation. A profit center is more likely to be autonomous, making its own intercompany pricing decisions and pricing policies to outside third parties, but this is not always the case.

**Divisions within the Company**

As a starting point in addressing divisional transfer pricing, consider a company that operates as two divisions, a manufacturing or production division and a selling division. The pricing alternatives are complex, even in this simple situation, as indicated by the following alternatives:

- **Autonomous transactions.** The production division determines the intracompany price on its own for the goods that it produces; the selling division determines the intracompany price on its own for the goods that it acquires.
- **Mandated transactions.** The intracompany price is determined by both the production division and the selling division acting together. The intracompany price is determined by the corporation rather than by its divisions.

**AUTONOMOUS TRANSACTIONS**

The following is an examination of the roles of the manufacturing or production division and the selling division from the standpoint of intracompany pricing and the application of autonomous transactions.

**Operations of the Production Division and the Selling Division**

The production division could be a profit center or merely a cost center. A cost center production division has no authority over intracompany prices, whereas a profit center production division might have this authority over intracompany prices.
At the outset, a production division that does have the authority over intracompany prices would be tempted to maximize its intracompany price, with a goal of maximizing net income for its own division. Then, bonuses and profit sharing for the production division should follow from the divisional results, assuming the corporation evaluates results based on bottom-line net income.

Similarly, a selling division could be a profit center or merely a cost center. A selling division that has authority to determine intercompany prices would be tempted to minimize its intercompany price, with a goal of maximizing net income from its division. Bonuses and profit sharing would then presumably follow from the divisional results, assuming the corporation evaluates results based on bottom-line net income.

Divisional autonomy is favored by managers in many situations because it gives the manager authority that is similar to that of corporate management. The corporation could more realistically base performance and rewards of the division on financial outcomes. The manager’s authority is equal to the financial responsibility. The autonomous divisional manager may have authority over capital investment decisions, output levels, and pricing of the final good, as well as intercompany pricing. Nevertheless, the transfer pricing regulations conspicuously ignore the possibility that autonomy could occur. Intercompany transfers take place as if they were at market when the division has autonomous decision-making authority.

Autonomy enables a division to purchase or sell to third parties, which can be affected by excess capacity or by spare plant capacity. Because the divisions are not required to trade with each other, internal transfers, if they occur, tend to be smaller in volume.

**Autonomy and Authority**

Autonomy between divisions gives each profit center the authority to set prices for itself and other divisions. Divisional autonomy is successful if the following situation applies:

- The production division has the authority to sell its products to outside parties rather than only to the selling division.
- The selling division has the authority to purchase its products from outside parties rather than only from the production division.

Providing a division with full authority over intercompany pricing is not viable unless the previously mentioned conditions apply. In this scenario, each profit center is a distinct business, having a pricing strategy that is independent of the pricing strategy of the other profit center. Each division determines whether to engage in transactions with internal sources (the other division within the group) or with external sources (third parties). These transactions are not mandated. In essence, the ability to sell or purchase products from the outside market serves as a safety valve.

**Applications**

When working as a university professor in economics in the Soviet Union during communist times, this author observed that the lack of divisional autonomy among
businesses could lead to market collapse. Many corporate structures in the United States and elsewhere do not permit divisional autonomy, as a facet of the market mechanism, to work correctly. Instead, corporate leaders dictate transfer pricing; however, the market mechanism does not readily apply to intercompany transfers because comparables and competition often do not exist.

Phrased differently, exchange autonomy is viable if there are comparables, necessitating that the comparable uncontrolled price (CUP) method must be viable, whether or not it is the best method. For example, the autonomous divisional structure would apply to a canner of foodstuffs in which the growing division is autonomous from the canning and selling division. The growing division could sell the foodstuffs elsewhere if the canning and selling division establishes its price below the market price. The canning and selling division could buy the foodstuffs elsewhere if the growing division establishes its price that is above the market price. The presence of autonomous transactions tends to mandate against unitary transaction treatment for state tax purposes, which can be advantageous or disadvantageous, depending on the circumstances of the business.

Objections to Divisional Autonomy

Autonomy among profit center divisions poses the danger that a profit center could optimize its own results at the expense of corporate goals, such as a selling division that acquires goods externally when there is excess capacity in the production division. Autonomy would not be satisfactory in situations in which unique parts are produced or sold, or where intangibles are a significant factor. The presence or absence of divisional autonomy should be an indicia of the CUP method, but it is not recognized as such in the current Treasury transfer pricing regulations.

A company that is in unrelated businesses must depend on financial results of each division, which are beyond the control of any individual division under review; however, in such a situation there are few intercompany transfers. Moreover, higher-level managers cannot be very familiar with the details of these diverse businesses, and instead emphasize measuring, evaluating, and rewarding divisional performance. Autonomy does not work well when product design and development are an important facet of the business, such as a business in the growth phase of its life cycle, because the selling division should be able to affect product design and development.

Vertical Integration and Mandated Transactions

A corporation’s management could postulate that the production process and the sales process together would lead to efficiencies and other economic benefits. Such a company is likely to mandate the price for internal transactions. Mandated transactions are more likely to create unitary taxation for state tax purposes, which can be advantageous or disadvantageous, depending on the company’s circumstances.

Corporate headquarters using the mandated approach to determine transfer pricing can unilaterally determine prices between divisions. Mandated pricing had
been applied in other situations, in Russia, for example, during the communist period. Most corporations that mandate transfers determine the intercompany price based on full cost, whether they are full-cost transfers or actual-cost transfers, but some companies permit marginal costing. In contrast, intercompany pricing between divisions in Russia was often arbitrary, and the Russian accounting system did not reflect marginal costing.

The vertical integration approach views a division as a profit center only for external third-party sales, if they occur. Mandating full-cost transfers between the manufacturing division and the selling division based on full-cost transfers treats the manufacturing division almost as a cost center rather than as a profit center. This mandated full-cost transfer approach tends to emphasize the importance of the sales division in contrast to the manufacturing division. The unit that receives the product at full cost from the manufacturing division retains all the profits or losses on external sales of the final goods.

The selling profit center could be viewed as a distinct profit center for both internal sales and external sales. In that event, corporate management could mandate that transfers are at market, providing profit or loss to the manufacturer and to the seller. Mandated market-based transfers are analogous to autonomy in many respects. Each unit is held responsible for all profits and losses when it transfers the goods at market, as if it sold the entire output externally.

**MANDATED SALES VERSUS AUTONOMOUS SALES**

A number of transfer pricing issues remain after the decision between autonomous pricing and mandated pricing is made. Chief among these issues are the following:

- Cost accounting for unused capacity
- Accounting for product design and development

**Cost Accounting for Unused Capacity**

The selling division that is autonomous, having full profit and loss responsibility, is entitled to purchase goods externally, even though spare capacity exists internally. The production division that is autonomous, having full profit and loss responsibility, is entitled to sell the goods externally, even though spare capacity exists internally. The same situation may apply to a division that is subject to mandated full costing pricing rules but has the authority to buy or sell independently. Potential sales of intercompany transactions may be lost to unrelated manufacturers in these situations.

A cost-based transfer pricing approach causes difficulties for businesses that have unused capacity and other sunk costs. The initial culprit is the full-costing rules themselves, which require total costs to be spread among fewer units when the plant is not fully utilized. The ultimate culprit may be the Treasury rules, which require full costing and uniform capitalization and restrict the use of the practical capacity
method.\textsuperscript{1} The capacity issue is most severe when capacity utilization is less for the manufacturing division than it is for competitive manufacturers. The manufacturing division must then allocate a portion of the unused fixed capacity costs to profit structure that will make the product uncompetitive.

**Product Design and Development**

The selling division and the manufacturing division might not have coordinated product design and development appropriately and might not have an occasion to coordinate with each other when the divisions are autonomous. The selling division might be working with outside suppliers for the product design and the development of new items or components. The manufacturing division or other internal suppliers may be outside the loop and fail to develop the skills or technology to produce the new items or components, causing a loss of business.

**ADMINISTRATIVE ASPECTS OF TRANSFER PRICING**

The administration process of determining a company’s transfer pricing practice is affected by factors such as the following twelve considerations:

1. Corporate goals and strategies
2. Divisional control, whether autonomous or mandated
3. Authority over transfer pricing: general managers, financial managers, and other executives in the decision-making process
4. Management style and conflict resolution
5. Corporate culture
6. Information utilized for the transfer pricing decision
7. Frequency of transfer pricing change
8. Technology and innovation of the product
9. Market characteristics of the product
10. General business conditions
11. Accounting system
12. Cost accounting system

A discussion of six factors follows: the range of transfer pricing activities, the scope of management activities, the information utilized, timing, conflict resolution, and the management style.

**Range of Transfer Pricing Activities**

Activities to establish the intercompany transfer price can range from mandated rules, set up by top management, on the one hand, to pure negotiation on the other

\textsuperscript{1} Treas. Reg. § 1.471-3.
hand. Mandated pricing rules, as so determined for intracompany pricing, could be similar to the following examples:

- Fully allocated cost plus 20 percent
- Resale cost less 15 percent
- The closing price for the commodity quoted in the financial press during the preceding day, less two basis points

**Scope of Management Activities**

Transfer pricing could be determined by a number of executives in various capacities, including the following, for example:

- Corporate-level managers
- Financial managers
- Managers in the selling division
- Managers in the selling division and the production division
- Combination of any of these

**Information Utilized**

Managers can rely on a number of types of information in setting transfer pricing, including the following:

- Corporate records
- Division records
- Cost data
- Market data
- Comparative data

**Timing**

Timing could affect the frequency and timing of transfer pricing adjustments, such as:

- Periodic (daily, weekly, monthly, quarterly, or annually)
- Episodic (based on other events, such as comparative market conditions, cost changes, currency changes, changes in the borrowing rate, or the like)

**Conflict Resolution**

Transfer pricing conflicts are inevitable because divisions of a business have different transfer pricing strategies. Businesses that recognize that these conflicts will occur may seek to minimize these conflicts, while still recognizing that conflict resolution is part of the process by which pricing is determined. Conflict resolution could include the following tactics:

- Force
- Conciliation
- Bargaining
Management Style

A number of businesses, as well as what was the Soviet Union itself, have resolved pricing disputes by force. In a bygone era, this approach was viewed as “father knows best.” The concept underlying this dictatorial approach is that the leaders have access to information that is unavailable to others farther down the chain. The users of that approach would argue that the information is difficult to convey and hard to apply, and would be duplicative. They would argue that the leaders, whether by birthright, education, or otherwise, are better able to dictate these decisions.

Some businesses attempt to resolve divisional pricing disputes by conciliation, perhaps even having a mediator within the corporation who could resolve these disputes; however, the mediation process is cumbersome. Businesses that use this process limit this approach by limiting the device to an infrequent period, such as once a year, and limiting the process to major divisions within the business.

Other businesses attempt to resolve divisional pricing disputes by bargaining. Businesses that apply this approach would argue that this process most fairly approximates a true market price; however, use of bargaining is cumbersome in its own right and should be limited in a manner similar to that of the conciliation approach.

Many businesses employ a mixture of the three conflict resolution techniques. Conciliation is suggested as the preferred method, but it is rarely applied and is used only when major events occur. Most conflicts are decided by force.

CORPORATE AND DIVISIONAL VANTAGE POINTS

Divisions of a business have a different point of view than the corporation as a whole when it comes to transfer pricing. There is no easy example as to which approach is best, as the following examples illustrate the fact that grouping transactions is beneficial in some cases but not in others.

Basic Example

Assume, in this fact pattern for both examples, that the business has two divisions, Manufacturing Division X, which produces the initial product, and Manufacturing Division Y, which completes the product. The production work done by Manufacturing Division X can be used in Manufacturing Division Y if the situation warrants. Division X can sell the incomplete products to third parties; alternately, Division Y can sell the completed products to third parties.

EXAMPLE 1

Grouping of Transactions Is Beneficial

Assume that Manufacturing Division X produces Product A, with a standard variable cost of $6 per unit. Manufacturing Division X has a choice in this example,
either to sell Product A to outside customers for $9 or transfer Product A for $6 to Manufacturing Division Y. Division X could break even by making the intracompany sales to Division Y or could earn a profit of $3 per unit by making external sales. In the normal course of events, Division X would prefer to make the external sales.

Manufacturing Division Y could purchase Product A for $6 from Manufacturing Division X, process Product A at a standard variable cost of $5, and sell Product A to unrelated parties for $16. Division Y would make a profit of $5 (sales price of $16, less transfer price of $6, less variable cost of $5). The sale of Product A by Manufacturing Division X to a third party would prevent Division Y from gaining income from this product.

In this scenario, Division X would prefer to sell Product A to the outside world rather than transferring the product to Division Y. Division Y would prefer to have the opportunity to contribute, and the company as a whole would benefit from the interaction of Division X and Division Y. The better course would be to mandate the transfer between Division X and Division Y at a division price of $9. In that event, Division X would earn $3 and Division Y would earn $2.

<table>
<thead>
<tr>
<th>Beneficial Aggregation</th>
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<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Division X Profit</td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>Division Y participates</td>
</tr>
<tr>
<td>Division Y does not participate</td>
</tr>
<tr>
<td>Composite approach</td>
</tr>
</tbody>
</table>

**EXAMPLE 2**

**Grouping of Transactions Is Detrimental**

Assume, in this fact pattern for Example 2, that the business has two divisions, Manufacturing Division X and Manufacturing Division Y. The production from Manufacturing Division X can be used in Manufacturing Division Y if the situation warrants. Assume further that Manufacturing Division X produces Product A, with a standard variable cost of $6 per unit. Manufacturing Division X can either sell Product A to outside customers for $12 or transfer Product A to Manufacturing Division Y for $6. Division X would break even by making intracompany sales and would earn a profit of $6 per unit through external sales.

In this scenario, Division X and Division Y standing together would have income of $5 (sales price of $16 less standard costs of $6 in Division X less standard variable costs of $5 in Division Y); however, a direct sale by unrelated purchasers would increase the entire income to $6. In essence, Division Y had negative income of $1, reflecting the market price of Product A rather than the cost of Product A.
Detrimental Aggregation

<table>
<thead>
<tr>
<th></th>
<th>Division X Profit</th>
<th>Division Y Profit</th>
<th>Total</th>
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<tr>
<td>Division Y participates</td>
<td>0</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Division Y does not participate</td>
<td>6</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Composite approach</td>
<td>6</td>
<td>0</td>
<td>6</td>
</tr>
</tbody>
</table>

Under this approach, Division Y does not participate and is not entitled to any portion of the income. All of the profit is attributable to Division X.

**Cost-Basis Approach—Equal Contribution Margin**

The evaluation of divisions and divisional profitability may rely on a sharing of the total contribution margin among these divisions. This contribution margin can be divided between the production division and the selling division or between the two production divisions. The contribution margin can be allocated pro rata on the basis of variable cost.

**EXAMPLE**

Business Y has two divisions, Division A and Division B. Division A sells all of its products to Division B. Division B sells the goods to the open market for $30. The variable costs are $6 for Division A and $4 for Division B, or $10 in total. The profit margin or operating income (revenues less variable costs) is $20 in total ($30 minus $10). The company could use a cost-base apportionment, treating the operating income or the profit margin of each division as proportionate (i.e., equal as a percentage of cost), thereby apportioning $12 to Division A and $8 to Division B.

<table>
<thead>
<tr>
<th></th>
<th>Division A</th>
<th>Division B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>18</td>
<td>12</td>
<td>30</td>
</tr>
<tr>
<td>Variable cost</td>
<td>6</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>Profit margin</td>
<td></td>
<td></td>
<td>20</td>
</tr>
<tr>
<td>Apportionment</td>
<td>12</td>
<td>8</td>
<td>20</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td>30</td>
</tr>
<tr>
<td>Income</td>
<td>12</td>
<td>8</td>
<td>20</td>
</tr>
</tbody>
</table>

Tax authorities may not necessarily approve the cost-basis apportionment and equal contribution margin approach. Divisions may have unequal risks or functions that would preclude equal treatment for variable costs. Note that this ratio is similar to that advocated by Dr. Berry.²

Profitability Apportionment

Businesses can apportion profitability on the following basis:

- Variable costs
- Standard costs
- Negotiation

Businesses may permit divisions to negotiate the allocation of the profit margin. Regrettably, this negotiation process may be time consuming, may lead to conflicts, and may be suboptimal from the standpoint of the entire company. Moreover, this negotiation process favors executives with negotiation skills rather than executives who can produce goods efficiently.

The negotiated approach is not necessarily advantageous. It is easier to convert a cost center to a profit center if the contribution margin is not negotiated. This transfer pricing approach is consistent with management decentralization through the use of profit centers. As such, the motivational advantages may be retained by use of a variable cost apportionment process.

Converting cost centers into profit centers through the use of an apportioned contributed margin technique may encourage cooperation between divisions. Divisions are encouraged to act together because the ultimate profit of each division depends on the contribution margin received by the company as a whole. All divisions will benefit from the cost efficiency that each division achieves. Each division then retains the motivational advantages of having a profit center as it complements the profit orientation as to third-party transactions. Both divisions together act as a profit center.

Apportionment of income among divisions may encourage cooperation. Moreover, this apportionment process can encourage competition among divisions that are similarly situated. Consider a situation in which Division A manufactures Product X and Divisions B, C, and D assemble Product X. Divisions B, C, and D perform the same functions and have similar assets and risks; intracompany transportation charges are similar for each division. Overall profitability can be maximized when Division A connects with the assembly division that is most efficient, a goal that would be sought by the business as a whole. Thus, each division would be concerned about the others’ cost of performance and level of production or sales.

Pro Rata Sharing of the Benefits of Cost Reduction

The apportionment of variable income among divisions may lead to cooperation between the divisions, but this transfer pricing strategy has one negative side effect. A division that reduces its costs is not entitled to the entire benefit and must share this benefit with other divisions. The saving that a division retains is then proportionate to the split of the contribution margin.
EXAMPLE

Assume that, in the preceding example, Division A reduces its variable costs from $6 to $4. Total variable costs for Division A and Division B then are $8 ($4 from Division A and $4 from Division B). The profit margin or operating income would then be $22, reflecting revenues of $30 and variable costs of $8. Operating income would then be $11 for each division.

\[
\begin{array}{|c|c|c|}
\hline
\text{Division A} & \text{Division B} & \text{Total} \\
\hline
\text{Revenue} & 30 \\
\text{Variable cost} & 4 & 4 & 8 \\
\text{Profit margin} & 11 \\
\text{Apportionment} & 15 & 15 & 30 \\
\text{Revenue} & 11 \\
\text{Income} & 11 \\
\hline
\end{array}
\]

Division A had caused variable costs to decrease by $2, which increased operating income or net margin by $2. The application of cost-based apportionment for operating income reduces Division A’s operating income by $1 (from $12 to $11) because of the cost savings that Division A engendered, a clear disincentive for cost savings. Division B’s operating income would increase by $3 (from $8 to $11) as a result of Division A’s $2 cost saving.

Constant Ratio Apportionment Method

The constant ratio apportionment method (apportionment determined before the cost reduction) might be viewed as less distortive. The original variable cost between Division A and Division B was 60 percent and 40 percent, respectively. The $2 cost reduction increased the profit margin from $20 to $22. This apportionment method would be retained and applied to the profit margin, which then becomes $13.2 (60 percent of $22) and $8.8 (40 percent of $22), respectively. This division of profits would be reflected as follows:

\[
\begin{array}{|c|c|c|}
\hline
\text{Division A} & \text{Division B} & \text{Total} \\
\hline
\text{Revenue} & 30 \\
\text{Variable cost} & 4 & 4 & 8 \\
\text{Profit margin} & 13.2 \\
\text{Apportionment} & 17.2 & 12.8 & 30 \\
\text{Income} & 13.2 \\
\hline
\end{array}
\]

This approach enables both divisions to share the benefits from the cost savings. Division A and Division B share the savings proportionate to the original split of the contribution margin.
Entire Benefit Approach

The third approach is to give the entire benefit to the division that earned the benefit, in this case to Division A, for reducing costs from $6 to $4. Division A’s revenue is unchanged at $18, but income increases from $12 to $14.

<table>
<thead>
<tr>
<th></th>
<th>Division A</th>
<th>Division B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>30</td>
<td>0</td>
<td>30</td>
</tr>
<tr>
<td>Variable cost</td>
<td>4</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>Profit margin</td>
<td>14</td>
<td>8</td>
<td>22</td>
</tr>
<tr>
<td>Apportionment</td>
<td>18</td>
<td>12</td>
<td>30</td>
</tr>
<tr>
<td>Income</td>
<td>14</td>
<td>8</td>
<td>22</td>
</tr>
</tbody>
</table>

Summary of the Results

The results of these apportionment methods can be summarized as follows:

<table>
<thead>
<tr>
<th></th>
<th>Division A</th>
<th>Division B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original apportionment</td>
<td>12</td>
<td>8</td>
<td>20</td>
</tr>
<tr>
<td>Pro rata sharing</td>
<td>11</td>
<td>11</td>
<td>22</td>
</tr>
<tr>
<td>Constant ratio method</td>
<td>13.2</td>
<td>8.8</td>
<td>22</td>
</tr>
<tr>
<td>Entire benefit approach</td>
<td>14</td>
<td>8</td>
<td>22</td>
</tr>
</tbody>
</table>

Some companies consider the entire benefit method to be the most accurate under the rationale that the division that created the benefit earns the benefit. Other companies recognize that both divisions must work together to achieve the benefit for all. These companies use the constant ratio approach.

DETERMINING THE NUMBER OF PROFIT CENTERS

A company may be tempted to have many profit centers, dividing existing profit centers when needed. This approach is said to lead to the following two benefits:

1. More profit centers lead to more management opportunities, especially for general managers and general managers to be.
2. The presence of more profit centers facilitates more diversity of product lines.

Each manufacturing profit center must be self-sufficient from a production capacity standpoint. Economies of scale should apply, so that multiple plants making the same product should be as efficient as one large plant. This multiple profit center technique may lead to a high level of independence among profit centers, reflected in substantial transfers between profit centers.
BY-PRODUCTS AND JOINT PRODUCTS

The characterization of products as either by-products or joint products is an important issue that the transfer pricing regulations have not addressed. This issue is most relevant in situations in which a cost method, such as the cost plus method, could be applicable. The joint product approach divides the costs incurred by some rational method, such as weight of the products, volume, or another criterion. The by-product method does not treat the subsidiary products as products per se, but treats the revenue from these subsidiary products as an offset to the production costs of the underlying principal product.

The joint product/by-product issue applies to many petroleum products, chemicals, and agribusiness products. Consider the following agribusiness examples:

- A rendering facility converts fat and bones into tallow and meal. A question arises as to whether meal is a by-product or a joint product. Allocation of the production cost based on weight may create losses for meal and profits for tallow sales. The by-product method, by offsetting the meal revenues, may reduce tallow income. This issue is important for foreign tax credit and interest charge domestic international sales corporation purposes because tallow is likely to be exported, but meal is rarely exported.

- Peanuts can be sold shelled or unshelled. A question arises as to the treatment of the shelling process. After shelling, the shells could be used for feed or for construction material. A question arises about whether the shells could be viewed as a joint product or a by-product. The latter approach would reflect the sale of the shells in determining the cost of peanuts.

- The ginning process results in cotton and seeds. The seeds have a use because they are used to produce cottonseed oil, which is often used in food products or as cooking oil. A question arises about whether the seeds are a joint product or a by-product and whether the hulls are a by-product or a joint product.

- Cattle are slaughtered into commercial-grade products, such as steak, and other products such as liver, tongue, heart, and offal products. The latter category of goods may be sold overseas, perhaps creating foreign tax credit or export benefits. A question arises about whether these products could be treated as by-products, enabling them to be taken into account without any allocation of cost.

COSTING ALTERNATIVES

A profit center is most likely to transfer products to another profit center using one of the following three methods:

1. At actual full cost
2. At standard full cost
3. At market-based transfer price
A company tends to apply one of the full-cost transfer techniques when the company has an aggregate combined profit center and has multiple divisions that are profit centers.

**APPLYING MANDATED FULL-COST TRANSFER PRICING**

Transfer prices can be set in one of two ways under the mandated full-cost transfer method:

1. Actual manufacturing division costs to make the product
2. The manufacturing division cost under a set of assumptions (i.e., standard costs to make the product)

The standard cost system compares standard costs to actual costs. The difference between these amounts, termed variances, includes raw material variances, labor variances, and other variances. The business must determine which division has the responsibility for each variance. The standard cost system seeks to compare the following items at the volume of units produced:

- Actual costs at the cost center
- Standard costs at the cost center

Standard costs should take all production costs into account, including, for example, assumptions about volume, production efficiencies, and access to raw materials. Actual costs are subtracted from standard costs, and this difference is viewed as a variance. Positive variances occur when actual costs are lower than standard costs; implicitly, management has succeeded in some manner to create a positive variance. Negative variances occur when actual costs are higher than standard costs; implicitly, management has failed in some manner to create a positive variance.

The concept of mandated full-cost transfers indicates that the transfer price is determined by the corporation in advance. A division must abrogate its own authority over prices. The division must give priority to internal demand rather than benefit from third-party sales. Mandated full-cost transfers restrict other divisions’ authority as well, because they prevent other divisions from sourcing the goods externally. A second division may prefer to buy from other sources because of quality, cost, or timing. Mandated full cost transfers reduce profit responsibility to the divisions, especially as profit centers, to the extent that the profits from intermediate goods are reduced to accommodate divisional sales.

**FULL STANDARD COST TRANSFER PRICES**

Using full standard cost to transfer goods from division to division lessens the extent to which the performance of one profit center affects the performance of other profit
centers. Standard costs are set in advance and are known before the transfer begins. Both divisions know the transfer price before the exchange takes place. Such is not the case for full actual-cost transfer pricing. The performance of a division that transfers goods at full standard cost is not affected by conditions that are beyond its control. Standard cost transfers are performance measures that reflect divisional responsibility that is commensurate with managerial authority. Transfers of goods at standard cost more clearly pinpoint financial responsibility than do transfers of goods at actual cost.

The presence of a procedure that transfers goods at actual cost signifies that the financial performance of each division engaging in the transfer is related to other divisions. Standard cost transfers diminish this interdependence but provide more meaningful results.

**BEHIND THE STANDARD COST SYSTEM**

**Issues in Applying Standard Cost Systems**

Standard cost systems are open to a number of vagaries, including the following:

- Assumptions
- Results of engineering studies
- Estimates of future costs
- Information utilized
- Control systems

When applying a standard cost system, a company should take into account a number of components, including cost and availability of raw materials, labor contracts and other labor issues, energy consumption and consequences of deregulation, advances in technology, and the like.

**Timing of Modifications**

The standard cost system must change over time to reflect new facts. A standard cost system that remains static leads to a proliferation of variances that may become unwieldy. Ultimately, such a standard cost system loses credibility. However, frequent changes in the standard cost system mean that the standards are not standard. Standard costs are often computed annually but take into account adjustments for raw material. Companies use criteria such as the following to change their standard costs:

- On an as-needed basis
- On a monthly basis
- On a quarterly basis
- Annually
- Under different criteria
Variance Analysis

Profit centers have an incentive to identify which variances they can and cannot control. The profit centers should receive positive variances and negative variances depending on whether the events are under their control. Control, in this case, may be quite limited and can be affected by currency fluctuations, fluctuations in material costs, and business conditions. Disputes concerning variances are likely to occur even if all profit centers accept the full-cost transfer pricing policy. After all, these variances affect measures of cost and profitability for measuring, evaluating, and rewarding performance.

A profit center can separate three types of variances based on responsibility:

1. Volume
2. Efficiency
3. Purchasing

These variances are most often viewed as attributable to the production division, not to the selling division, except for external sales; however, assignment of responsibility is difficult. For example, interruptions can be created by selling division requests that interfere in production runs. These variances should be attributed to the selling division.

Variances are a measure of performance for the profit center, giving the profit center incentives to excel. Performance measures should pertain to desired goals, whether that is current income, an accretion in wealth, or return on assets. The measurement process that would establish standard costs gives the appearance of being scientific, but the process is often subjective, especially in the transfer pricing context.

MANDATED MARKET-BASED TRANSFER PRICING

Mandated transfer pricing policies can be significantly different from mandated full cost. A company could attempt to use third-party pricing to determine its intracompany market-based transfer price. This process tends to be complex at the divisional level, just as it is for intercompany transfers. Transfer pricing issues arise in two specific situations:

1. The volume of intercompany sales is extremely large compared with third-party sales.
2. Internally transferred products differ from products sold externally.

Using External Sales to Determine Intracompany Sales

Application of external sales data to determine the transfer price for intracompany sales faces a number of obstacles:

- The production division may be a large producer of the goods, both in absolute terms and as a percentage of the relevant market, limiting the ability of the production division to secure comparable sales, aside from sales to the selling divi-
sion. In addition, oligopsonistic considerations may cause the production division to deviate from any true market price.

- The selling division may be a large purchaser of the goods, both in absolute terms and as a percentage of the relevant market, limiting the ability of the selling division to secure comparable purchases, aside from purchases from the purchasing division. In addition, oligopsonistic considerations may cause the selling division to deviate from any true market price.

- The production division may be a large producer of the goods at the same time that the selling division may be a large purchaser of the goods, both in absolute terms and as a percentage of the relevant market. Comparables are unlikely in this situation because either or both divisions are likely to achieve sufficient economies of scale.

- External data may itself be distortive in a number of circumstances, including the following:
  - The seller may be undertaking oligopolistic practices.
  - The purchaser may be undertaking oligopsonistic practices.
  - A supplier may have excess capacity and may reduce prices to increase utilization of the capacity.
  - A supplier may attempt to make use of special circumstances such as marginal costing. Afterward, that supplier may increase prices.
  - The supplier may be uninformed about the market as a whole or the costs of production or distribution.
  - The product may be sold in a different form, for example, in less-finished form, when sold to other divisions.
  - The product may have different specifications for external sales than for divisional sales.

The production cost center and the selling cost center may view supplier relationships and customer relationships differently. Supplier relationships are important to the production cost center regarding the quality of materials, reliability of delivery, determination of accounts payable and the collection, and cost. Supplier relationships may affect the selling cost center directly only to the extent of the cost of the items acquired by the production cost center. Customer relationships are important to the selling cost center regarding continuity of the relationship, determination of accounts receivable and payment, and other factors. Customer relationships may affect the production cost center only to the extent of the effects on the immediate sale.

**Making Changes to the Intracompany Transfer Price**

The decision to change intracompany transfer prices differs between companies. Some businesses change their intracompany transfer prices on a current basis; others change their intracompany transfer prices only infrequently, even if the business utilizes market-based transfer pricing. Factors influencing this decision should include the following:

- The magnitude of the changes in cost, whether direct labor, outside vendors, raw materials, or the like
The change in external prices  
Administrative difficulties in changing intracompany transfer pricing

**Impact on Pricing of Final Goods to Third Parties**

A relationship exists between intracompany transfer pricing (and intercompany transfer pricing) and the price to third parties. Consider the following situations:

- The company may impose minimum margins on the sale of final goods to third parties. The selling division might choose to forego that business if its margins are below that threshold, even if this business would be profitable for the company as a whole. Alternately, the selling division may keep its margins high to meet these threshold requirements, but in so doing the company may attract competition.
- Neither the production division nor the selling division may have long-term responsibility for the product. Neither division will maintain the competitive strength of the final product, to do what has to be done to keep the product viable over the long term. The business suffers from lack of research and development (R&D) on a long-term basis, but the benefit is short-term savings.

**COST-PLUS MARKUPS**

Most companies transfer goods from one division to another without any “plus” or other markup. A few companies use a plus if they can tie the plus to third-party sales, but this situation is infrequent. Other companies add overhead and profit, but often little thought has been given to ascertaining the plus. Following are some of the approaches utilized for intracompany transfer pricing, related to cost-plus markups:

- The company anticipates the profit from both divisions as a whole and weighs the contributions of each. This analysis leads to a contribution margin for the production division. This approach is complex and is infrequently applied, except to major product lines.
- The markup is based on a constant rate of return for the product line.
- The average profit becomes the markup for the center.
- A standard gross margin is used for the profit center.
- A company uses an arbitrary margin, such as “cost plus 10 percent.” In many situations, no thought has been given to ascertaining the magnitude of the “plus” nor even to the rationale behind the “plus.”

Conflicts can arise because of cost-plus pricing. The production profit center will most likely become aware of costs of the selling profit center, and the selling profit center will become aware of the costs of the production profit center. Both parties will have sufficient information to dispute the magnitude of the markup, even if the company has a goal of achieving a fair profit for each. These disputes often can be resolved by comparing proportional contributions of the divisions. Market-based
transfer pricing does not lead to such a full analysis, because this data is not likely to be made available to each party.

APPLYING THE RESALE METHOD TO INTRACOMPANY TRANSFERS

Some companies use a resale method to determine the intracompany markup. The selling division solicits competitive bids from external suppliers for comparable final products. The markup from the production division to the selling division is determined by subtracting internal selling costs from the external suppliers’ bids.

A company seeking such a bid may face certain risks. In providing bidders with sufficient information to make a bid, it may be giving the bidders sufficient information to go into competition. The intracompany transfer price is often a markup on costs, whether these costs are actual costs or standard costs. The markup should reflect economies of scale, such as the benefits from increased volume resulting from fixed costs being spread among more units. Instead, many companies determine their intracompany pricing by relying only on variable costs.

The production profit center has no incentive to reduce costs if it is entitled to a standard percentage markup. In fact, the production profit center will increase its income by being less efficient. Under this pricing formula, profits of the production division will increase as the base (i.e., costs) increases proportionally. Businesses would be better off requiring a constant markup (i.e., cost plus fixed fee), a pricing device often used for federal contracts. Both the production cost center and the selling cost center should coordinate and cooperate in designing proprietary technology. Both cost centers should work together to discuss design requirements and other long-term issues.

TRANSFER PRICING IMPLICATIONS FOR AUTONOMOUS BUSINESS UNITS

Fiscal authorities almost universally treat an autonomous business unit that is within a larger corporate group as a non sequitur for transfer pricing purposes. Only the Australian transfer pricing regulations appear to consider business autonomy as relevant. This chapter demonstrates that the concept of an autonomous business unit is inherently viable and that autonomous business units should be recognized as such for transfer pricing purposes.

Governmental authorities have long concluded that pricing decisions are determined solely by monolithic, multinational corporations that, for their own ends, seek to minimize overall tax obligations as their primary and perhaps sole objective. As such, these governments have categorically rejected the concept that a business unit, such as a division or a subsidiary, could undertake its independent decision-making process on its own, separate and apart from the goals of the corporate group as a whole. Thus the fiscal authorities would deny the essential character of an autonomous business unit for transfer pricing purposes.
Empirical Evidence

A study by Ernst & Young nearly contemporaneous to the transfer pricing regulations themselves reflects the government view of corporate objectives. The Ernst & Young 1997 *Global Survey* reported that “a common view apparently held by fiscal authorities worldwide is that tax optimisation is always the driver behind transfer pricing policies.”[^3] In fact, this governmental view of the corporate decision-making process is substantially erroneous, as we shall see.

The findings in the *Global Survey* show that the goal of “optimising tax arrangements” is a high priority in only 25 percent of the participants, with “maximising operating income performance” in first place with 45 percent, and “documentation in preparation for audit” being tied with “optimising tax arrangements” at 25 percent. The other main priorities are “financial efficiencies” (24 percent) and “performance incentives” (11 percent), with double counting being permitted. The *Global Survey* examination of subsidiary respondents reinforces the view that nontax objectives are primary: “Optimising tax arrangements is a main priority in shaping transfer pricing policy for just 18 percent of the United States and 8 percent of the European survey population.”[^4]

Basic Pricing Approaches

It is important to define *mandated pricing* and *autonomous pricing*. A mandated pricing regime enables corporate headquarters to dictate pricing to business units and, at the same time, curtails the power of a business unit to buy goods from outside parties rather than from affiliated business units and curtails the power of a business unit to sell goods to outside parties rather than to affiliated business units. Mandated pricing diminishes the power of business units as profit centers but may increase economic synergies. Autonomous pricing, conversely, permits a business unit both to buy from outside parties rather than the affiliated business units and to sell to outside parties rather than to affiliated business units. Autonomous pricing diminishes economic synergies but may increase individual initiative among business unit managers.

Decision-Making Alternatives

We revisit the decision-making process from a transfer pricing standpoint. What we find in fact is that a plethora of decision-making options exist, with mandated pricing and full autonomous pricing being at both extremes of the transfer pricing spectrum. Probing further, we find that such factors as business economics, state tax law concepts, and innate concepts of the company and its intended role in the world all play a role in pricing.

At this juncture, to examine this plethora of transfer pricing concepts, it is important to review transfer pricing decisions that would be made independently of

[^4]: Id.
any tax consequences. First we consider a business that operates solely through one corporation in one taxing jurisdiction. Then we expand from this analysis.

Most businesses operate through cost centers (which, as the nomenclature dictates, accumulate costs) and profit centers (which determine revenues in addition to costs). Large profit centers, or groups of profit centers, become business units within the corporate structure.

Virtually all businesses transfer goods and services from one division to another, and in so doing use a cost basis for intracompany pricing in an overwhelming number of situations. In contrast, applying the “best method” for transfer pricing purposes in these situations provides vastly different results, because businesses rarely use the resale method or the comparable profits method for internal purposes.

Although the intracompany transfer takes place at cost, there is some question about how costs are determined. The cost could be actual cost or standard cost. Standard costs most typically require projections as to the output, and often require inputs from economists and cost accountants to the production process.

The transfer pricing regulations eschew non-numerical transfer pricing methods. Decision-making theory and human behavior carry little weight with fiscal authorities.

Transfer Pricing Implications

The Section 482 contemporaneous documentation rules, including the existing records requirement of Treas. Reg. Section 1.6038A-3(c)(4) (with its cross-reference to Treas. Reg. Section 1.6662-6(d)(2)(iii)(C) regarding background documents), can be applied to require that the taxpayer provide the IRS with interdivisional accounting records. The IRS can assert that these records must be made available on the basis that they are prepared “in the ordinary course of its business operations” and are “created or compiled” by “any member of the related party group.” Nevertheless, the taxpayer may have a number of grounds for contesting this discovery.

A multinational business transferring its work-in-progress goods almost uniformly determines the transfer price on a cost basis. As a general matter, comparables for work-in-process goods do not exist. A disparity in transfer prices is likely because, on the one hand, these businesses apply a cost basis for the transfer for internal purposes, and on the other hand, the businesses are often compelled to use one of the profit split methods as their quest for the best method for tax reporting purposes.

While comparables are often difficult to obtain for transfer pricing purposes, comparable transactions can be obtained almost automatically if a business unit truly has the autonomy to sell its goods within or without the corporate group. Such an autonomous entity would act for its own interest in selling goods to outside parties or the corporate group. Similarly, a purchasing comparable should exist if a business unit truly has the autonomy to purchase goods or work in process from another business unit or from unrelated parties.

Central headquarter functions, such as management, control, financing, marketing, and advertising, decline in importance when a business unit is autonomous.
Furthermore, a business’s place within the mandated pricing/autonomous pricing spectrum affects the potential for unitary status of the business for state income tax purposes.

**Business Issues**

Mandated transfers are transfers of goods that are dictated by top management. As such, there are unilateral transfers of goods between business units, most typically at full actual cost or at full standard cost. Mandated pricing, including mandated transfers of goods, tends to emphasize the importance of the sales activities and deemphasize the importance of the production activities.

Product design and development can change the focus of the conflict between autonomous pricing and mandated pricing. Unit autonomy most typically provides the production unit with much more control over product design and development than the selling unit has; however, the input of the selling unit into product design and development decisions is essential during the growth phase of the life cycle. As a result, the autonomous selling unit may be working with outside suppliers rather than with the affiliate production units for product design and development. Consequently, business autonomy tends to be disadvantageous when product design and development are important for profitability of the business.

Close collaboration between production units and sales units tends to increase profitability in some situations but not in others. This collaboration, if successful, may increase profitability because of business efficiencies and other economic benefits. In those situations, mandating transaction prices should maximize profitability. In other situations, however, business autonomy would maximize profitability.

**Autonomy and Authority**

Autonomy between business units should give each profit center the authority to set prices for itself. Business autonomy is more likely to be successful if the following situations apply:

- The production unit has the authority to sell its products to outside parties rather than only to the selling unit.
- The selling unit has the authority to purchase its products from outside parties rather than only from the production unit.

**Delineating Business Autonomy**

Tax regimes should have the capacity to delineate autonomous pricing structures and mandated pricing structures and to recognize gradations in between for transfer pricing purposes. Even if this approach were to be recognized across the board, the taxpayer would have to demonstrate that the business unit is, in fact, autonomous. The parameters for determining business autonomy could be those such as the following:

- Contractual agreements and other memoranda, whether from the business units or from corporate headquarters, denote the autonomy of the business unit in
fact, including pricing documents such as bids from related parties and from unrelated parties.

- Significant risks and rewards applicable to the business unit are present, including significant incentives for the business unit, such as profit sharing, for example, that relate to relative level of autonomy of the business unit.
- Disputes among autonomous business units are resolved through conciliation or bargaining, not by force.
- De facto control is reflected by the presence of decision-making powers at the business unit level (e.g., the importance of traders as recognized by Notice 94-40).
- The economic nature of the business as it relates to feasibility of business autonomy. Business autonomy tends to be more viable for market-based transfers such as raw materials, grain, and other fungibles and less viable for producers of unique goods or businesses with oligopolistic or oligopsonistic strategies.

### Viability of the Autonomous Business Concept

Following are two situations, the first being one in which mandated pricing would be advantageous for the corporate group as a whole. This illustration supports the approach taken by fiscal authorities in denying that a business unit could be autonomous. In the second example, autonomous pricing would be advantageous for the corporate group as a whole. This illustration refutes the approach taken by fiscal authorities in denying that a business unit could be autonomous.

#### EXAMPLE 1

**Mandatory Pricing Is Beneficial**

Assume, in this first fact pattern, that the business has two business units, Manufacturing Unit X, which produces the initial product, and Manufacturing Unit Y, which completes the product. The production from Manufacturing Unit X could be used in Manufacturing Unit Y if the situation warrants. Manufacturing Unit X could sell the incomplete product, Product A, to third parties. Alternatively, Manufacturing Unit Y could sell the completed product, Product B, to third parties. Manufacturing Unit X produces Product A at a cost of $8 each. Outside customers would pay $11 each for Product A. Sales between Manufacturing Unit X and Manufacturing Unit Y are at cost. The cost of converting Product A to Product B is $5 per unit.

Manufacturing Unit X has a choice in this example, selling Product A to outside customers for $11 or transferring Product A at a cost of $8 to Manufacturing Unit Y. Manufacturing Unit X could break even by selling Product A to Manufacturing Unit Y or could earn a profit of $3 per unit by making external sales. In the normal course of events, Manufacturing Unit X would prefer to make the sales externally.

Manufacturing Unit Y could purchase Product A for $8 per unit from Manufacturing Unit X, process Product A at a cost of $5 per unit, and sell Product A to unrelated parties for $18 per unit. Manufacturing Unit Y would make a profit of $5
per unit (sales price of $18 per unit, less transfer price of $8 per unit, less variable cost of $5 per unit). The sale of Product A by Manufacturing Unit X for $3 per unit would preclude Manufacturing Unit Y’s income of $5 per unit.

In this scenario, Manufacturing Unit X would prefer to sell Product A to the outside world rather than transferring the product to Manufacturing Unit Y. Manufacturing Unit Y would prefer to have the opportunity to sell Product B to the outside world. The company as a whole would benefit from the involvement of both Manufacturing Unit X and Manufacturing Unit Y. Here, mandated pricing would increase total income from $3 per unit to $5 per unit.

**EXAMPLE 2**

**Mandatory Pricing Is Detrimental**

Assume, in this fact pattern, that the business has two divisions, Manufacturing Unit X and Manufacturing Unit Y. The production from Manufacturing Unit X could be used in Manufacturing Unit Y if the situation warrants. Assume further that Manufacturing Unit X produces Product A at a cost of $8 per unit. Manufacturing Unit X could sell Product A to outside customers for $14 per unit or transfer Product A at a cost of $8 per unit to Manufacturing Unit Y. Manufacturing Unit X would break even by selling Product A to Manufacturing Unit B or could earn a profit of $6 per unit from external sales.

In this scenario, Manufacturing Unit X and Manufacturing Unit Y standing together would have income of $5 per unit (sales price of $18 per unit less costs of $8 per unit for Manufacturing Unit X less costs of $5 per unit for Manufacturing Unit Y); however, a direct sale to unrelated purchasers would increase the entire income to $6 per unit. Thus mandated pricing from Manufacturing Unit X to Manufacturing Unit Y would be detrimental.

**Transfer Pricing Decision Making**

Although fiscal authorities believe that worldwide tax optimization is always the driver behind transfer pricing policies, other variables enter into the picture, including the following:\(^5\)

- The presence of autonomous business units, when they occur
- Market position of the product, including oligopoly or oligopsony
- Customs duties and enforcement
- Inflation or deflation, whether current or anticipated, including currency fluctuation, hedging costs, and currency control mechanisms
- Production capacity, including plant efficiency

\(^5\) See the “Mandated Sales versus Autonomous Sales” Section, this chapter.
Governmental relationships
Corporate goals and strategies
Authority and control of general managers, financial managers, and other executives in the decision-making process
Management style and conflict resolution
Corporate culture
Quality and quantity of the information utilized for the transfer pricing decision
Frequency of transfer pricing changes
Technology and product innovation
General business conditions
The accounting system
The cost accounting system

CONCLUSION

Intracompany transfer pricing involves many of the same issues as does intercompany transfer pricing, most often without the input of the relevant tax collectors; however, solutions to these issues differ between intracompany transfer pricing and intercompany pricing. Expediency tends to be more important because the volume of transactions tends to be larger and the size of the transactions tends to be smaller.

Corporate taxpayers should encourage fiscal authorities to accept the concept of business autonomy, recognizing that gradations between autonomous price structures and mandated price structures may well be the norm. At the least, comparability studies that reflect these gradations should be recognized by fiscal authorities. Regulatory and legislative changes will ultimately be required in some jurisdictions; at present, corporate taxpayers should consider resorting to litigation to prove that an autonomous business unit should be treated as such for transfer pricing purposes.
The Treasury Department issued “General Principles and Guidelines” as part of the transfer pricing regulations, and asserts that these principles and guidelines are mandatory. The general principles and guidelines affect the substance of any transfer pricing transaction and thus this process is much more significant than having the status of procedural rules. The principles and guidelines require the taxpayer to apply three standards: the arm’s-length standard, the best method rule, and comparability analysis. All standards are discussed next.

BACKGROUND

The U.S. tax rules for transfer pricing are based on one central premise—that a taxpayer is dealing with another party at arm’s length for each transaction. The arm’s-length standard is designed to ensure that the taxpayer’s income is “clearly reflected” on the taxpayer’s tax return. The IRS can adjust income reflected on the taxpayer’s return and impose penalties if the taxpayer’s income is not clearly reflected. The transfer pricing procedure places a “controlled taxpayer” on a “tax parity” with an “uncontrolled taxpayer” to determine “the true taxable income” of the controlled taxpayer.

OVERVIEW

The Treasury’s “General Principles and Guidelines” require the taxpayer first to undertake a substantive analysis of its transactions and then to select its transfer price.
The chronology of this process is important. Furthermore, the taxpayer may have to preserve its substantive analysis through contemporaneous written documentation in order to avoid penalties that the IRS might assert. Three components of the substantive analysis are mandatory:

1. The taxpayer must use the best (transfer pricing) method.
2. The taxpayer must undertake a thorough comparability analysis.
3. The taxpayer must use the arm’s-length range to determine the transfer price.

Each of these facets of the substantive analysis merits our further attention, and are discussed in this analysis under major headings. Most taxpayers will find that the comparability analysis, in particular, is onerous; this method requires an analysis of five factors: functions, contract terms, risks, economic conditions, and property or services, each of which is described herein.

**BEST METHOD RULE**

The taxpayer is required to choose the best transfer pricing method. After the taxpayer has selected the best method, the IRS can review the selection and may require the taxpayer to substantiate the selection.

The theoretical arm’s-length standard looks to “the same transaction” under the “same circumstances” by uncontrolled taxpayers. In reality, this degree of sameness rarely or never exists. As a practical matter, the determination of the “arm’s-length result” may be based on “comparable transactions” under “comparable circumstances” when there are no identical transactions. The regulations recognize and deal with inexact comparables as well as with exact comparables.

The stated purpose of the transfer pricing regulations is to achieve an arm’s-length result of “true taxable income.” The arm’s-length result is to be based on a method that provides the “most reliable measure.” One and only one of the potential transfer pricing methods is the best method, depending on the taxpayer’s appli-

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8 Preamble accompanying the 1994 Transfer Pricing Regulations.
10 Treas. Reg. § 1.482-3(a).
11 Treas. Reg. § 1.482-1(c).
12 Treas. Reg. § 1.482-1(d).
13 Treas. Reg. § 1.482-1(e).
14 Treas. Reg. § 1.482-1(d).
15 Treas. Reg. § 1.482-1(c)(1).
16 Treas. Reg. § 1.482-1(b)(1).
17 Id.
18 Treas. Reg. § 1.482-1(c)(2)(ii).
19 Treas. Reg. § 1.482-1(a)(1).
20 Treas. Reg. § 1.482-1(c)(1).
cable facts and circumstances. Two primary factors determine the most reliable measure:

1. The degree of comparability between the controlled transaction and any “uncontrolled comparables”\textsuperscript{21}
2. The quality of the data and assumptions (e.g., the economic assumptions) that the taxpayer uses\textsuperscript{22}

Let us look specifically at the comparability requirement and then at data and assumptions.

**Comparability**

The general comparability rule mentioned previously describes the best method concept: Transactions are more reliable and comparable if there are fewer differences in these transactions, and are less reliable and less comparable if there are more differences in these transactions.\textsuperscript{23}

**Data and Assumptions**

The determination of whether the transfer pricing method is the most reliable measure depends on three facets that affect data and the assumptions:\textsuperscript{24}

1. Completeness and accuracy of the data
2. Reliability of the assumptions
3. Sensitivity of results to data and assumptions

The best method rule specifies that data is complete and accurate if the data enables the taxpayer to “identify and quantify” the factors that would “affect the result” under any particular method. Data is complete and accurate if they:\textsuperscript{25}

- Identify differences between controlled and uncontrolled transactions
- Ascertain the reliability of adjustments that are made to account for these differences

Reliability of the data depends on the soundness of the assumptions made by the taxpayer (or later perhaps by the IRS). All transfer pricing methods rely on certain assumptions, and these assumptions can be based on economic analysis or otherwise.\textsuperscript{26} Economic analysis can determine certain assumptions, such as price differ-

\textsuperscript{21} Treas. Reg. § 1.482-1(c)(2).
\textsuperscript{22} Id.
\textsuperscript{23} Treas. Reg. § 1.482-1(c)(2)(i).
\textsuperscript{24} Treas. Reg. § 1.482-1(c)(2)(ii).
\textsuperscript{25} Treas. Reg. § 1.482-1(c)(2)(iii)(A).
\textsuperscript{26} Treas. Reg. § 1.482-1(c)(2)(iii)(B).
ences that equate to the time value of money. Other assumptions may be less reliable.\(^{27}\)

The taxpayer’s database may be a principal determinant of the taxpayer’s selection of its transfer pricing method. Deficiencies in the database impact each transfer pricing method in a different manner, causing deficiencies in the data used or in the assumptions made to have greater impact on some transfer methods than on others.\(^{28}\)

### COMPARABILITY ANALYSIS

The comparability analysis uses a comprehensive analysis to compare transactions in establishing the arm’s-length price. A transaction is evaluated by comparing the results of the controlled transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. All factors that “could affect prices or profits” must be included in comparability analysis. Five factors are enumerated in the regulations:\(^{29}\)

1. Functional analysis
2. Contractual terms
3. Risk
4. Economic conditions
5. Property or services

These factors are not of equal weight. Some transfer pricing methods ascribe more weight to certain factors than to others.

A transaction need not be identical to be considered comparable; a transaction can be used as a comparable if the transaction is “sufficiently similar.”\(^{30}\) Transactions with material differences can be used if the adjustments are made; otherwise, the transactions can be used, but the reliability of these transactions is reduced. Adjustments are made to the uncontrolled comparable and must be based on one of the three bases:\(^{31}\)

1. Commercial practices
2. Economic principles
3. Statistical analysis

Now let us turn our attention to the other five factors.

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\(^{27}\) Id.

\(^{28}\) Treas. Reg. § 1.482-1(c)(2)(ii)(C).

\(^{29}\) Treas. Reg. § 1.482-1(d)(1).

\(^{30}\) Id.

\(^{31}\) Treas. Reg. § 1.482-1(d)(2).
Functional Analysis

Functional analysis is the first of the five factors that determine comparability. This transfer pricing study compares functions performed by a company and by other parties to determine the “degree of comparability” between controlled and uncontrolled transactions. The approach of a study is to determine two facets of functional analysis:

1. The functions performed
2. The resources employed that are associated with the functions

Functional analysis determines the functions performed and the associated resources employed in these functions, ascertaining both for controlled transactions and for uncontrolled transactions. The term “resources employed” pertains to activities undertaken or to assets used, such as plant and equipment, or to the use of “valuable intangibles.”

Functional analysis identifies and compares “economically significant activities.” Consequently, activities that are not economically significant presumably need not be taken into account in this analysis. Functional analysis includes the following activities in determining the comparability of two transactions:

- Research and development
- Product design and engineering
- Manufacturing, production, and process engineering
- Product fabrication, extraction, and assembly
- Purchasing and materials management
- Marketing and distribution functions, including inventory management, warranty administration, and advertising activities
- Transportation and warehousing
- Managerial, legal, accounting and finance, credit and collection, training, and personnel management services

The general approach to functional analysis is to start with the taxpayer’s mental concepts that led to the design for the product and end with the sales of the product to the ultimate consumer. Facts and circumstances determine this list of functions, and the previous list is not mandatory.

Functional analysis can be approached by listing all of the company’s economically significant activities (such as the list indicated previously), quantifying these activities, and then repeating the process for uncontrolled entities. In some situations, a company should consider preparing this list both for the producing and selling activities to comply with the best method transfer pricing requirements. The resources-employed analysis could be developed in a similar manner.

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32 Treas. Reg. § 1.482-1(d)(3).
34 Id.
35 Id.
Contractual Terms

The second phase of comparability analysis requires that the “significant contractual terms” be compared between the controlled and the uncontrolled transactions “that could affect the results” of the two transactions.\textsuperscript{36} The contractual terms that are important for this transfer pricing analysis could include the following:\textsuperscript{37}

- The form of consideration charged to the taxpayer or paid by the taxpayer
- The specific volume of sales or the specific volume of purchases
- The scope and terms of warranties provided by the seller or by the buyer
- Rights (in the case of intangibles) to updates, revisions, or modifications
- The duration, termination, and renegotiation rights for relevant license, contract, or other agreements
- Collateral transactions or “ongoing business relationships” between buyer and seller; includes arrangements for “ancillary or subsidiary” services
- Payment terms and extension of credit

Adjustments should be made to the transfer price if the difference between the transactions would have a “material effect on price.”\textsuperscript{38} Agreements that are in writing and made in advance of the transaction will be respected if the terms are “consistent with the economic substance of the underlying transactions.”\textsuperscript{39} Greatest weight is given to the “actual conduct” of the parties. If there is no written agreement, the IRS may impute a contractual agreement, giving greatest weight to the actual conduct of the parties.\textsuperscript{40}

Examples illustrate that differences in volume may be material, and that adjustments within established volume discounts can be ascertained by linear extrapolation, but that discounts beyond the established ranges in volume instead must be based on “proper economic or statistical analysis.”\textsuperscript{41} Furthermore, contractual terms can be imputed from economic substance, including the bearing of marketing expenses and an ensuing unstated right to use a trade name.\textsuperscript{42}

Risk

The third phase of comparability analysis requires a comparison of “significant risks” that “could affect prices or profits.”\textsuperscript{43} These transfer pricing risks could include the following:\textsuperscript{44}

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\textsuperscript{36} Treas. Reg. § 1.482-1(d)(3)(ii)(A).
\textsuperscript{37} Id.
\textsuperscript{40} Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2).
\textsuperscript{41} Treas. Reg. § 1.482-1(d)(3)(ii)(C).
\textsuperscript{42} Id.
\textsuperscript{43} Treas. Reg. § 1.482-1(d)(3)(iii)(A).
\textsuperscript{44} Id.
Market risks, which include fluctuations in cost, demand, pricing, and inventory levels
Research and development risks, the risks associated with the success or failure of the R&D activities
Financial risks, including fluctuations in the exchange of foreign currency and fluctuations in interest rates
Credit and collection risks
Product liability risks
General business risks, risks related to the ownership of property, plant, and equipment

The central issue in risk analysis from the standpoint of transfer pricing is to determine which party bears the risk. In general, the party who bears the risk is entitled to the rewards (i.e., profits or losses associated with the risks).

Contractual terms determine the party that bears the particular risk if the terms are consistent with “economic substance.” Economic substance refers to:

- The taxpayer’s “pattern of conduct over time”
- The financial capacity to bear the loss that is expected to occur in light of the assumption of the risk

Additionally, from the standpoint of “managerial or operational control,” both the risks and the control over the activities that give rise to the income or loss should be viewed together.

In identifying which party bears the risk, the examples in the regulation illustrate one situation in which a related party has “adequate financial capacity” and another situation in which the related party does not have the wherewithal to pay. A third example illustrates how currency risk can be shifted between the parties as long as each has adequate financial capacity to bear the currency risk. In the fourth example, an agreement concerning shifting the risk of product liability exposure is disregarded by the IRS because an affiliate business bears these expenses instead.

Economic Conditions
The fourth facet of the comparability analysis focuses on economic conditions that could affect transfer pricing. The “significant economic conditions,” such as the conditions that could affect prices or profits, determine the degree of comparability between controlled or uncontrolled transactions. These factors include the following:

46 Id.
52 Id.
The similarity of the geographic markets
The relative size of each market; the extent of the “overall economic development” in each market
The “level” of the market (e.g., wholesale, retail)
Market shares for products, properties, or services transferred or provided
“Location-specific costs” of the “factors of production and distribution”
The extent of the competition in each market for the product or service
The economic conditions of the particular industry; this life-cycle analysis focuses on whether the market is in the expansion phase or the contraction phase
Alternatives that are realistically available to buyer and seller

Property or Services

The fifth facet of transfer pricing comparability focuses on a comparison of the property transferred or the services transferred. Intangibles that are embedded in the property or services must be taken into account. A comparison of the property being transferred pertains to the physical likeness or similarity of the items.53

ARM’S-LENGTH RANGE

The General Principles and Guidelines require that the arm’s-length range be determined, the comparability analysis take place, and the best method be used. The regulations provide three approaches in determining the arm’s-length range:54

1. There is just one arm’s-length amount, so there is no range.
2. The arm’s-length range applies to comparable transactions.
3. The transactions are not quite comparable, and the arm’s-length range could be used if the results are truncated.

Most important, the taxpayer’s pricing will not be adjusted if the pricing is within the arm’s-length range.

Claiming the Full Arm’s-Length Range

A taxpayer can use the full arm’s-length range (the second alternative mentioned) if the transactions meet all of the following four criteria:55

1. Information on the controlled transaction and the uncontrolled comparable is “sufficiently complete.”
2. “All material differences” have been identified.

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54 Treas. Reg. § 1.482-1(e).
3. Each difference has a “definite and reasonably ascertainable effect” on price or profit.
4. An adjustment is made to eliminate the effect of each such difference.

**Truncated Range**

If the transactions do not meet the standards for obtaining the full range, a truncated range of arm’s-length results applies. The interquartile range (the two middle quarters, if the entire range is divided into four parts) or other statistical techniques can be used to truncate the range.⁵⁶

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A multinational enterprise by its inherent nature has facilities of many types located in many places in the world. Transfer pricing is a field of analysis that reflects the determination of profits of each such portion of the enterprise. The profits of each portion of the business are most typically structured through intercompany transactions, including intercompany sales, licensing, leasing, and the like. Transfer pricing is a field of analysis that reflects the price of goods, services, or intangible transfer between these entities, or, as an alternative, the determination of profits of entity for that activity having taken place within the enterprise.

TRANSFER PRICING AS A DECISION-MAKING PROCESS

Transfer pricing for an enterprise is a complex decision-making process. The process reflects many inputs and many constituencies of the enterprise. The inputs typically include diverse activities, including the cost of construction, marketing efforts, taxation, market share goals, and many other inputs of this type, including human behavior specialists, international tax practitioners, industrial engineers, economists, and many others. The constituencies typically include shareholders, employees, and customers.

The decision-making process typically involves inputs from various segments of the business. The transfer pricing decision is viewed differently by persons who can see one segment of the entire picture. It is rare that a person can see the entire picture and act on that picture.

TAX AND NONTAX CONSIDERATIONS

Some outsiders to a business view the business as making unilateral decisions, viewing the executives as having no goal other than maximizing short-term profitability of the worldwide business determined on an after-tax basis. These outsiders neglect to consider that businesses often use pricing structures designed to compete with out-
side interests, compete with executives in terms of executive compensation, and deal with long-term interest of suppliers. What makes the field of transfer pricing interesting is that the revenue authorities in many jurisdictions are such outsiders as described.

A business can view transfer pricing as a zero-sum analysis except for executive compensation and taxation, as profits would be the same regardless of the legal entity of physical location where the profits occur. Some businesses view the zero-sum features of transfer pricing as an excuse to avoid top-level transfer pricing adjustments. Other businesses split transfer pricing issues among transfer pricing tax executives and executive personnel.

ASCERTAINING WHO IS AT RISK

Transfer pricing decisions most typically take place among executives located in and representing affiliates in an enterprise or their own interest. This pricing decision affects the profitability of each legal entity within the affiliated group and the tax that is to be paid on the profits of each legal segment of the business.

Transfer pricing is, at the outset, a business decision and a tax decision. Income tax payments are a significant cost for most multinational businesses, and transactions between affiliated entities are an important part of this income tax exposure. Global transfer pricing is an analytical approach that enables a business to control its income tax cost on a worldwide basis. This global transfer pricing approach focuses only on transactions with related parties, so that relationships with independent entities are ignored. Other relationships, such as business partnerships between unrelated entities, remain a threshold inquiry for the tax collectors.

FOREIGN COUNTRY PARTICIPATION IN TRANSFER PRICING

More than 30 countries have somewhat standard approaches toward transfer pricing, typically through the Organization for Economic Cooperation and Development (OECD). Such countries include the following:

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BASICS OF THE TRANSFER PRICING INQUIRY

Global transfer pricing is complex and requires significant analytical inputs. A company seeking to use global transfer pricing should be able to answer the first 10 inquiries, using this information as a starting point for each country in which the company does significant business:

1. What transfer pricing methods are acceptable in the country?
2. What priority is there among transfer pricing methods?
3. What penalties can the country impose on your company?
4. When can you reduce the penalty that could otherwise be imposed?
5. What type of information must you provide to the tax collector?
6. Can you set up a pricing agreement with the tax collector in advance?
7. What adjustments and set-offs are required after a pricing adjustment?
8. When can you use a cost-sharing agreement with your affiliates?
9. What is the effective tax rate in your configuration in that country?
10. What is the effective withholding rate for international payments?

Transfer pricing issues impact both the businesses that may have to pay the taxes and the tax collectors that expect to collect the taxes. Quite fortuitously, and by design, transfer pricing rules across international borders are much more similar than they are different. These differences, however, lead to substantial tax consequences. Most differences typically lead to double taxation, but some occasionally lead to tax-saving opportunities.

TRANSFER PRICING REFERENCE MATERIALS

Information about U.S. transfer pricing policies and practices is readily convenient. While other references are available, the Transfer Pricing Handbook (John Wiley & Sons, Inc., 2001) has grown in stature among international tax practitioners. The third edition of the Handbook, edited by Robert Feinschreiber, is a two-volume series and includes a comprehensive supplement.


TRANSFER PRICING METHODOLOGIES

Governments most typically make their transfer pricing analysis on a legal entity basis so that transfer pricing focuses primarily on the legal ownership and control of legal entities. Very little attention is paid to branches or divisions from a transfer pricing perspective. The tax collector may examine contractual relationships, corporate partnerships, and other activities.
Transfer pricing, for tax purposes, depends on pricing in and of itself or on a split of net income among affiliated entities. Thus transfer pricing has two often conflicting objectives:

1. Determining an equitable share of the profits between taxing jurisdictions
2. Determining equitable prices for intercompany transactions

Most countries focus on the pricing or transactional approach and not on a profit split approach. Global trading is used for financial institutions.

**Specific Methods**

The standard transfer pricing methods include the following:

- Comparable uncontrolled price method
- Resale price method
- Cost-plus method
- Profit split

Countries do differ in their pricing methods, especially when it comes to the profit split alternative. There are many variations and cost accounting methods in determining cost. Value-based costing comes into play in determining the plus. Brazil’s transfer pricing methods differ most significantly from other countries.

**Comparability Analysis**

Some countries impose a priority in determining the applicable transfer pricing method. Other countries, including the United States, impose no specific priority. Their goal is to determine the best transfer pricing method, using parameters such as the following as part of a comparability analysis:

- **Functions of the business in each country.** Activity-based costing has an important role here.
- **Contract terms.** Including purchasing terms, licensing, and so forth
- **Risks.** Everything from bankruptcy to currency devaluation to slip-and-fall
- **Economic conditions.** Including riots, hyperinflation, tax incentives and the like
- Property or services in each country

**U.S. Transfer Pricing**

In practice, transfer pricing in the United States is based on the comparable profits method (CPM), which focuses on the U.S. activities of the business. This approach seeks comparative data between ostensibly similarly situated enterprises in the United States. Three comparable profits methods are in widespread use:

1. The ratio of operating profits to sales
2. The ratio of gross profits to sales
3. The ratio of operating profits to operating assets
Economists make a number of adjustments to establish the CPM, including the following:

- Inventory adjustments
- Accounts receivable
- Accounts payable
- Foreign exchange risk

**Comparable Profits Method and SIC Codes**

The taxpayer or the IRS frequently applies the easiest transfer pricing method, which is often the formulary CPM. The taxpayer or the IRS auditor often applies the CPM procedure by going to the Standard Industrial Classification (SIC) code and doing the following:

- Using the four-digit SIC code applicable to the business
- Including other businesses in that SIC code
- Preparing and utilizing CPM comparative formulas

At the present time, the SIC approach for transfer pricing is being abused and is fraught with difficulty. The six most serious transfer pricing problems for the taxpayer or the IRS examiner are as follows:

1. The initial selection of SIC may be determined by a staff person in the company who is unfamiliar with the ramifications of SIC selection or with transfer pricing.
2. Such an individual may not be adequately familiar with the operations of the business to adequately select the SIC code.
3. A four-digit SIC code is too broad-based and encompasses activities vastly different from the taxpayer under examination.
4. The SIC process does not adequately effect changes in the taxpayer’s business. Many businesses continue on with the SIC code by habit rather than by further analysis.
5. The SIC process does not contain an established process for changing a business’s SIC code.
6. The SIC code may become obsolete or obsolescent as high technology moves rapidly. Multiyear data would not be available under any event.

**Substantiating Transfer Pricing**

A taxpayer can avoid a detailed transfer pricing audit by preparing and retaining primary documents and background documents. The documents must be prepared in the ordinary course of business and cannot be prepared specifically for audit. Contemporaneous documentation includes the following:

- Business overview
- Organizational structure
- Section 482 documentation
Method selection
Rejected methods
Controlled transactions
Comparables
General index

TRANSFER PRICING PENALTIES IN THE UNITED STATES

The United States has a complex transfer pricing penalty regime that is separate from penalties that could apply to taxpayers in other contexts and from the special penalty rules that could apply to foreign-owned U.S. corporations. These penalties are not deductible in determining gross income. There are, in fact, two transfer pricing penalties:

1. Transaction penalty
2. Net adjustment penalty

There are two penalty levels:

1. Substantial valuation misstatement penalty—20%
2. Gross valuation misstatement penalty—40%

All penalties apply to Section 482–related tax underpayments. Each type of penalty can apply at either of the two levels mentioned. The penalty applies to the tax, not to underpayment itself. Tax underpayment is the difference between the result reflected on the tax return and the results as finally determined.

Substantial Misstatement Penalty

The substantial valuation misstatement penalty applies if the price stated is twice as much as the true price or is half as much as the true price. Consider the two examples:

1. The parties select an intercompany price of $4,000.
   The true price was $8,000.
   The 20% substantial valuation misstatement penalty applies to the difference.
2. The parties select an intercompany price of $4,000.
   The true price was $2,000
   The 20% substantial valuation misstatement penalty applies to the difference.

Gross Misstatement Penalty

The gross valuation misstatement penalty applies if the price stated is four times as much as the true price or is one-quarter as much as the true price. Consider the two examples:
1. The parties select an intercompany price of $4,000.
   The true price was $16,000
   The 40% gross valuation misstatement penalty applies to the difference.
2. The parties select an intercompany price of $4,000.
   The true price was $1,000
   The 40% gross valuation misstatement penalty applies to the difference.

Net Adjustment Penalty

The net adjustment penalty is the most significant of the two transfer pricing penalties, especially for large and medium-sized multinationals. In contrast to the transactional penalty, which is determined on a transaction-by-transaction basis, the net adjustment penalty is determined on an aggregate basis. There are two levels in applying the net adjustment penalty:

1. Substantial valuation misstatement penalty
2. Gross misstatement penalty

The substantial valuation misstatement applies to the net adjustment penalty if the net Section 482 adjustment is the lesser of the following:

- $5 million
- 10% of gross receipts

Substantial Valuation Misstatement Net Adjustment Penalty

The substantial valuation misstatement net adjustment penalty could be recharacterized in the following manner:

- Gross receipts of less than $50 million—valuation based on 10% of gross receipts
- Gross receipts of $50 million—valuation of $5 million
- Gross receipts of more than $50 million—valuation of $5 million

The gross valuation misstatement applies to the net adjustment penalty if the net Section 482 adjustment is the lesser of the following:

- $20 million
- 20% of gross receipts

The gross valuation misstatement net adjustment penalty could be recharacterized in the following manner:

- Gross receipts of less than $100 million—valuation based on 20% of gross receipts
FOREIGN-OWNED BUSINESSES DOING BUSINESS IN THE UNITED STATES

Foreign-owned U.S. companies that are doing business in the United States could be subject to two U.S. tax regimes. The business has a dual tax responsibility if:

- A business is engaged in intercompany transactions.
- A principal shareholder of the business is foreign.

The two U.S. tax regimes include the following:

1. Transfer pricing
2. Foreign-owned U.S. corporation reporting and record keeping

These two regimes have different objectives and, as such, interrelate on specified occasions. This portion of the chapter specifically addresses the rules for foreign-owned U.S. corporations.

Responsibilities Imposed

The U.S. tax law imposes extensive responsibilities on foreign-owned U.S. corporations. The U.S. tax law also imposes responsibilities on foreign owners, but these responsibilities are only derivative (i.e., the responsibilities relate to the parent–subsidiary relationship) and limited in scope. This peculiar relationship toward foreign owners exists because the United States recognizes that its long arm of the U.S. tax law is limited by international law concepts and does not apply directly to foreign owners. The full responsibility falls on the U.S. subsidiary because the U.S. courts have power over this subsidiary because of its presence in the United States.

Foreign-owned U.S. corporations have two responsibilities:

1. To prepare and retain specified records
2. To file specified documents with the IRS

The foreign-owned U.S. corporation provisions may potentially have the following impact on the U.S. company:

- May cause the U.S. company to be subject to penalties
- May require the U.S. company to enter into an authorization agreement with the foreign owners
- May subject the U.S. company to a summons
- May subject the U.S. company to special harsh penalties for noncompliance
Reporting Requirements

Foreign-owned U.S. corporations must file Form 5472 annually to reflect intercompany transactions with each affiliate. For example, a foreign-owned business has four subsidiaries overseas and three subsidiaries in the United States. Assume that each entity in the United States does business with the four subsidiaries of the parent and the parent itself. Each U.S. entity would have to file five Forms 5472. Because there are three U.S. subsidiaries, 15 Forms 5472 would be needed in all.

The term U.S. owner is broader than the ownership and control of a subsidiary. In fact, the tax rules require that the U.S. company reflect a shareholding of 25 percent or more. The relevant term is a reporting corporation. Partnerships and branches are treated in the same manner as branches.

Form 5472 must reflect U.S. dollars, even if principal currency was not the U.S. dollar. U.S. currency tax rules are used to determine the U.S. tax amount. Nevertheless, Form 5472 is an information return, not a tax return. Section 6038A permits the reporting corporation to use approximations. Estimates are considered reasonable if the estimates range between 75 percent and 125 percent of the actual amount. The IRS and the courts determine this actual amount.

The English language must be used for all purposes in preparing documents and filing the requisite forms to the IRS. The businesses can use foreign-language documents and retain documents overseas, but the business must be prepared to translate these documents into English and have these documents made available to the IRS. The reporting party and the foreign-related party can contest in court the amount and the extent of the documents sought by the IRS.

The IRS could request virtually every record that exists and some that do not exist. Instead of requiring all of these records, the Treasury Regulations enable the reporting corporation to prepare and retain 100 or so separate records. The Treasury provisions call this provision a “safe harbor” and a part of the contemporaneous documentation rules. Nevertheless, tax practitioners view this provision as an “unsafe harbor.” Preparing less than all of the documents may enable the IRS to expand rather than contract its investigation. The section 6038A safe harbor provisions have no parallel in the section 482 provisions. Section 482 has no safe harbors.

Specific Database Requirements

There are six components to the section 6038A safe harbor provisions:

1. Original entry books and transaction records
2. Profit and loss statements
3. Pricing documents
4. Foreign country and third-party filings
5. Ownership and capital structure records
6. Records of loans, services, and other nonsale transactions

The reporting corporation is obligated to prepare and retain many types of records. In some cases, the reporting corporation has an obligation to create records
if these records otherwise did not exist. This rule applies to original entry books and transaction records which include the following:

- General ledgers
- Sales journals
- Purchase order books
- Cash receipts books; cash disbursement books
- Bank statements; canceled checks
- Workpapers
- Purchase invoices; sales contracts

**Six Reporting Levels**

The U.S. tax rules require more reporting for big companies and for big transactions than they do for small businesses and for small transactions. There are six reporting levels in all.

1. By type of transaction $50,000
2. Related-party gross payments $5,000,000
3. U.S. gross receipts $10,000,000
4. Gross receipts—penalty exclusion $20,000,000
5. Significant industry segments $25,000,000
6. High profit test $100,000,000

**Penalties on Foreign-Owned U.S. Corporations**

The specific rules for foreign-owned U.S. corporations contain three penalties:

1. Initial penalties
2. Additional penalties
3. Noncompliance penalties

It is important to note that these specific penalties that can apply to foreign-owned U.S. corporations are separate from the penalties that could apply to section 482 transfer pricing. As such, foreign-owned U.S. corporations that made transfer pricing errors are subject to two penalty regimes. These penalties are not deductible in determining gross income.

The penalties for foreign-owned U.S. corporations are based on the number of Forms 5472 required to be filed, which for a typical large multinational can be more than 100 Forms 5472 per year. If 10 U.S. subsidiaries of the foreign parent have the requisite transactions with foreign subsidiaries, 100 Forms 5472 must be filed, and up to 100 penalties of $10,000 could be assessed for such failures, $1 million in total. The initial penalties are imposed annually.

The IRS can impose an initial penalty on a reporting corporation that fails to comply with the following:

- Reporting requirements imposed by section 6038A
- Record maintenance requirements imposed by section 6038A
The initial penalty is $10,000 and can be imposed for each such failure. Nevertheless, the penalty does not apply to minor failures. Instead, the penalty is imposed if the information required is “substantially incomplete.” Three specific failures invoke the initial penalty:

1. Failure to furnish the information return, Form 5472, within the time and manner prescribed by the regulations
2. Failure to maintain records under the record maintenance rules, or failing another party to maintain records under the record maintenance rules
3. Failure to meet the requirements for records outside the United States within the requisite time period

Additional penalties can apply if the IRS notifies the reporting corporation in writing that the reporting corporation failed to meet its compliance obligation and this failure continues for 90 days. At that point, the additional penalty begins to apply. The additional penalty is $10,000 for each 30-day period. A fraction of the 30-day period is treated as the entire 30-day period.

More penalties can apply if the IRS requests the requisite tax information, but the reporting corporation is not forthcoming in providing this information. In that situation, the IRS can deny all deductions claimed. In addition, criminal penalties may apply for the reporting corporation that fails to file a tax return or files a false or fraudulent tax return.

A reporting corporation might be able to escape from penalties if the reporting corporation can demonstrate the following:

- The reporting corporation has reasonable cause for its actions or inaction.
- The reporting corporation has substantially complied with the record-keeping and reporting obligations.
- The reporting corporation has proven the facts and circumstances were such to deny the penalty.
- The reporting corporation acted in good faith.
- The reporting corporation’s failure resulted from an honest misunderstanding.

INTRODUCING THE ADVANCE PRICING AGREEMENT PROCESS

The United States has long advocated advance pricing agreements (APAs). Similar advanced agreements are available in more than 20 countries. There are two types of APAs:

1. Unilateral APAs. Between the taxpayer and the IRS
2. Bilateral APAs. Between the taxpayer and the IRS, the foreign taxpayer, and the foreign tax authorities

The APA procedure in the United States involves the following steps:
1. One or more prefiling conferences
2. Paying a fee for the APA
3. The APA request for an APA
4. An establishment of critical assumptions in the APA
5. The APA agreement
6. Preparation of an annual report to the IRS describing APA activities
7. Audit-limiting activities
8. Record retention
9. Continuation of the APA
10. Cancellation of the APA

A global transfer pricing analysis most often reduces income tax payments in one or more jurisdictions, making the entire effort invariably worthwhile for the business as a whole.
Applying Specific Transfer Pricing Techniques
his chapter analyzes the transfer pricing regulations that reflect the traditional methods of determining tangible transfers: the comparable uncontrolled price method, the resale price method, and the cost-plus method. The reader must bear in mind, however, that the taxpayer can select a transfer pricing method only if all three standards are met for the method being selected:

1. The “best method rule” applies
2. The “comparability analysis” applies
3. The “arm’s-length range” applies

Also, the reader is cautioned that a nontraditional transfer pricing method (the comparable profits method, the profit-split method, or unspecified methods) may be the best method in specific instances. Nevertheless, the resale price method or the cost-plus method may be both the transfer pricing method of choice and the best method when the taxpayer has in-house comparables.

**Comparable Uncontrolled Price Method**

The comparable uncontrolled price (CUP) method requires the taxpayer to evaluate whether the amount charged in a controlled transaction is arm’s-length. This
method compares a “controlled transaction” with “a comparable uncontrolled transaction.”

Comparable data can be obtained from two sources:

1. A taxpayer seeking to use the CUP method should prepare an analysis of prospective uncontrolled transactions and adjust the data.
2. The IRS may accept data from “public exchanges and quotation media” in determining the uncontrolled transactions.

**Direct Analysis of CUP Data**

A taxpayer may obtain data directly to determine whether the data is comparable. Whether or not the transactions are viewed as comparable under the CUP method depends on “close similarity” of these transactions. Many factors determine the comparability of transactions under the CUP method, including, most important, the similarity of products. Product similarity can be ascertained in two ways: directly or by applying adjustments that account for differences between the uncontrolled transactions and the controlled transactions. Even minor differences in contract terms or economic conditions of the controlled transactions could materially affect the amount charged in uncontrolled transactions. These minor differences in contract terms or economic conditions could be “material.”

**Differences between Similar Products**

The first step in applying the direct CUP method is to categorize the total differences (if any) between the controlled transactions and the uncontrolled transactions into one of the following four categories:

1. No differences
2. Minor differences
3. More than minor differences
4. Material product differences

The taxpayer then is to apply the relevant comparability criterion (outlined as follows) to one of the four categories:

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9 Treas. Reg. § 1.482-3(b)(5).
11 Treas. Reg. §§ 1.482-3(b)(2)(ii)(A) and 1.482-3(b)(5).
13 Id.
1. No differences This method will be the most direct and reliable method of determining arm’s-length price; the best method applies to this situation.

2. Minor differences Differences are definite and reasonably ascertainable, and adjustments for differences can be made; the method will be the most direct and reliable method of determining the arm’s-length price; the best method applies to this situation.

3. More than minor differences The CUP method can be used, but reliability of results is reduced; accordingly, the CUP method may not be the best method.

4. Material product differences Reliable adjustments cannot be made; the CUP method ordinarily is not the best method.

Differences and Adjustments

The taxpayer should adjust the differences (if any) between the uncontrolled transaction and the controlled transaction. The differences could include the following items on the list, which is nonexclusive:

- **Quality of the product.** Fineness (of precious metals), moisture (of grain), duration, absence of flaws
- **Contract terms.** The scope and terms of warranties provided, volume of sales or purchases, credit terms, transport terms, choice of forum, choice of law
- **Level of the market.** Wholesale, retail, other distributor arrangements
- **Geographic market.** Place in which the transaction takes place (typically a country)
- **Date of transaction**
- **Intangible property associated with the sale**
- **Foreign currency risks**
- **Alternatives realistically available to buyer and seller**

Direct CUP Method: Examples

The regulations provide four examples of the direct CUP method. The regulations also provide two examples of quotation media to determine the CUP method, which is discussed later in this analysis.

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15 Treas. Reg. § 1.482-3(b)(4).
16 Treas. Reg. § 1.482-3(b)(5)(iii).
EXAMPLE 1

Comparable Sales of the Same Product

A U.S. manufacturer sells the same product—widgets—to both uncontrolled distributors and controlled distributors. The transactions to the distributors are identical, except as follows:

- Controlled sales prices include delivery to the uncontrolled distributor.
- Uncontrolled sales are f.o.b. factory.

Differences in this transaction pertain only to transportation and insurance. Differences in contractual terms for transportation and insurance generally have a “definite and reasonably ascertainable effect on price.” The differences are “minor differences,” so that the CUP method is potentially applicable.

The best method to use is the CUP method, adjusting the transportation and insurance differences. Here the CUP method will provide the most direct and reliable measure of an arm’s-length result.

EXAMPLE 2

Effect of a Valuable Trademark

The facts in Example 2 are the same as Example 1, except that the U.S. manufacturer affixes its valuable trademark in controlled transactions, but does not affix its valuable trademark in uncontrolled transactions. The trademark, being valuable, has a material impact on price. The impact of the trademark cannot be reliably estimated.

In essence, the application of a valuable trademark destroys comparability needed to use the CUP method. The CUP method is unlikely to provide a reliable measure of the arm’s-length result, and the method is unlikely to be the best method because of these differences.

EXAMPLE 3

Minor Product Differences

The facts in Example 3 are the same as Example 1, except that the U.S. company manufactures business machines. The company modifies the business machines in some situations but not in others.

The company makes minor modifications to the physical properties of the business machines to satisfy the specific requirements of a controlled sale, but does not make these modifications in uncontrolled sales. The nature of the modifications are not addressed in the example. The adjusted results “may be” (or “maybe”—a typo in the regulations) used as a measure of the arm’s-length result if the minor physical difference in the product have a material effect on prices.
**EXAMPLE 4**

**Effect of Geographic Differences**

A foreign specialty retailer sells radios to a controlled distributor serving the west coast of the United States and uncontrolled distributors serving other regions in the United States. Except for the geographic differences, the product and other circumstances for the sale are the same.

The selection of the pricing method depends on whether the geographic differences have a material effect on price. If the differences cause a material effect on price, our inquiry turns to whether the differences have definite and reasonably ascertainable effects and whether the adjustments could be made. Adjusted results of the uncontrolled sales can be used if the geographic differences are unlikely to have a material effect on price, or if the geographic differences have definite and reasonable effects that could be adjusted for.

Reliability is diminished if the effects of the geographic differences are material, but these differences cannot be reliably ascertained. Nevertheless, the CUP method may still provide the most reliable measure of an arm’s-length result.

**Public Exchanges and Quotation Media**

The comparable uncontrolled price method enables the use of data from public exchanges or quotation media to ascertain a comparable uncontrolled price, but the data is termed *indirect evidence.* This secondary evidence can be used only if three requirements pertaining to dissemination, use, and adjustments are met, and one limitation is satisfied. As a result, the use of public exchanges and quotation media to determine CUP is difficult to apply and is limited, except for the sale of grain or in similar industries. The requirements and limitation are as follows:

- Three requirements apply to the dissemination of data:
  1. The data is widely and routinely used.
  2. The data is used in the ordinary course of business in the industry.
  3. The data is used to negotiate prices for uncontrolled sales.

- Two requirements apply to the use of data that has already been obtained:
  1. The data is used to set prices in the controlled transaction.
  2. The data is used in the same way by uncontrolled taxpayers in the industry.

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17 Treas. Reg. § 1.482-3(b)(5)(i).
18 Treas. Reg. § 1.482-3(b)(5).
19 Treas. Reg. § 1.482-3(b)(5)(i)(A).
20 Treas. Reg. § 1.482-3(b)(5)(i)(B).
Adjustments may be needed to reflect the seven primary differences between a transaction undertaken by the controlled party and by transactions undertaken by uncontrolled parties:

1. Product quality
2. Quantity
3. Contractual terms
4. Transportation costs
5. Market conditions
6. Risks borne
7. Other factors that affect the price that would have been agreed to by uncontrolled taxpayers

The use of data from public exchanges or quotation media is limited, so that data from public exchanges and quotation media may not be appropriate under “extraordinary market conditions.”

Indirect Evidence to Determine CUP: Examples

The transfer pricing regulations provide two examples that describe the use of indirect evidence to determine CUP data. Examples of the direct CUP method are discussed earlier in this analysis.

EXAMPLE 1

Use of Quotation Media

A U.S. company and its foreign subsidiary agreed that the parent would purchase crude oil from the subsidiary based on local published prices, the average price published in a quotation medium. The price was computed for a five-day interval, based on the date set for delivery. The parent and its foreign subsidiary agreed to adjust the price for the particular circumstances of their transactions, including the following:

- Quantity of the crude oil being sold
- Contractual terms
- Transportation costs
- Risks borne by the parties
- Other factors that would affect price

The quotation medium used by the parties is “widely and routinely used in the ordinary course of business in the industry” to establish prices for uncontrolled sales. The data is used to set prices between the related parties, and appropriate adjust-

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21 Treas. Reg. § 1.482-3(b)(5)(i)(C).
22 Treas. Reg. § 1.482-3(b)(5)(ii).
23 Treas. Reg. § 1.482-3(b)(5)(iii).
24 Treas. Reg. § 1.482-3(b)(4).
ments are made to account for the differences. Accordingly, the price derived from the quotation medium “will be considered evidence” of a CUP.

**EXAMPLE 2**

**Extraordinary Market Conditions**

The facts in Example 2 are the same as Example 1, except that before the U.S. company and foreign subsidiary enter into their contract, a war breaks out between major oil-producing countries. The foreign subsidiary is located in a different country, and this country is not a participant in the war. The war causes significant instability in world petroleum markets. As a result, prices listed on the quotation medium may not reflect a reliable measure of an arm’s-length result.

**Products Suitable for the CUP Method**

Taxpayers should consider using the CUP method for the following product categories:

- **Extracted raw materials** (gold, silver, copper, aluminum ingot, crude oil, heating oil, fuel oil, gasoline, etc)
- **Harvested crops** (wheat, corn, soybeans, soybean oil, castor oil, cottonseed, cotton meal, cotton oil, sugar, and so on; perhaps barley, oats, castor beans, cotton, etc.)
- **Animal products** (cattle, offal, pork bellies, hides, tallow, etc.)
- **Fungible chemicals** (aspartame, saccharin, ammonia, fructose, etc.)
- **Other fungible goods, without brand name** (pens, pencils, paper clips, computer disks)
- **Other fungible goods, with brand name** (soft contact lenses)

As a general rule, the CUP method could apply to standard, identical, and fungible commodities (i.e., commodities that per se are not specifically identified). Often, the product itself is subject to precise definition and a trade association monitors trade in that commodity.

**RESALE PRICE METHOD**

The resale price method is typically used to determine profitability of a distributor, in the same way the cost-plus method is typically used to determine the profitability of a manufacturer. The resale price method assumes that it is easier for a distributor to determine its gross margin than it is for the manufacturer to determine its cost.

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25 Treas. Reg. § 1.482-3(c)(1).
based pricing. Correspondingly, the cost-plus method assumes that it is easier for a manufacturer to determine its cost-based pricing than it is for a distributor to determine its gross margin.

**Basic Facets of the Resale Price Method**

Six facets apply to the resale price method:

1. The “resale price” is the price from the distributor (or reseller) to the customer. The transfer price is the price to the customer, less the applicable gross margin earned by the distributor. As a result, some practitioners often call this method “the resale minus method.”
2. The applicable gross margin is based on the gross profit margin realized in comparable uncontrolled transactions, subtracting the appropriate gross profit from the applicable resale price. Gross margin is expressed as a percentage of total revenue derived from sales. Gross profit is sales less the cost of goods sold. For example, a widget having an inventory cost of $60 is sold for $100. The gross profit margin is ($100–$60)/$100=$40/$100, or 40 percent. The resale price is the sales price of $100, less the gross profit of $40, or $60 in total.
3. The resale price method measures the value of functions performed.
4. The resale price method ordinarily is used in the purchase and sale of tangible property.
5. The resale price method assumes that the reseller has not added substantial value to the tangible goods by physically altering the goods before resale. Packaging, repackaging, labeling, or minor assembly does not ordinarily constitute physical alteration.
6. The resale price method is not ordinarily used when the “controlled taxpayer” (presumably, the regulations are referring to the distributor here) uses its intangible property to add substantial value to the tangible goods.

**Comparability and the Resale Price Method**

Five specific factors apply to the resale price method:

1. The determination of whether the resale price method provides the most reliable measure of an arm’s-length result is determined under the “best method” factors.
2. Functional comparability is the most important factor under the resale price method, and risks borne and contractual terms are nearly as important.
3. Other comparability factors are taken into account, with physical similarity of lesser importance.
4. Adjustments for differences between controlled and uncontrolled transactions should be made when material differences between controlled and uncontrolled transactions would affect gross margin.
5. Commission and buy–sell transactions are treated as being equivalent.

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26 *Id.*
27 Treas. Reg. § 1.482-3(c)(3).
Transactions should be compared as part of the taxpayer’s transfer pricing analysis. The taxpayer is to assess the extent of the comparability between a controlled transaction and an uncontrolled transaction in evaluating the resale price method. The general comparability provisions apply, encompassing five factors: functions, contractual terms, risks, economic conditions, and property or services.\(^{28}\) Items 2, 3, 4, and 5 in the preceding list are discussed next.

**Functional Comparability**

A reseller’s gross profit provides compensation to the reseller for the performance of resale functions. Compensation includes an operating profit in return for the initial capital investment and the assumption of risks.

Five factors must be considered to determine this compensation.\(^{29}\) Comparability under the resale price is particularly dependent on the similarity of functions performed, risks borne, and contractual terms, with comparability of economic conditions and property or services lesser in importance.

In-house sales are accepted and sought under the regulations.\(^{30}\) Uncontrolled sales by the reseller take precedence over wholly independent transactions in assessing comparability of the controlled sales. If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale. Wholly independent sales between an unrelated supplier and an unrelated customer are not required or even sought. Similar characteristics of the transaction are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers; however, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers if comparable uncontrolled transactions involving the same reseller are absent.

**Other Comparability Factors**

The resale price method requires a comparison of five factors, but comparability under this method deemphasizes comparability of the physical products. As a result, comparability under the resale price method is less dependent on close physical similarity than under the CUP method.\(^{31}\)

The following example prepared by the author illustrates the deemphasis of physical product comparability under the resale price method.

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\(^{28}\) Id.
\(^{29}\) Treas. Reg. § 1.482-3(c)(3)(ii)(A).
\(^{30}\) Id.
\(^{31}\) Treas. Reg. § 1.482-3(c)(3)(ii)(B).
distribution functions. The distributors are performing these functions without regard to the specific durable goods being distributed; that is, these consumer durables may be distributed in the same manner, despite differences between a refrigerator and a microwave oven, or between a refrigerator and a fax machine. Thus, it is to be expected that controlled and uncontrolled transactions would involve the distribution of products of the same general type (e.g., consumer electronics in the preceding example). As a result, some or all products could be grouped together for comparative purpose.

The regulations specify that substantial differences in products may indicate significant functional differences between the controlled and uncontrolled taxpayers.32 The presence or absence of trademarks, in and of itself, does not preclude the use of the resale price method.33 However, significant differences in the value of the distributed goods—due, for example, to the value of the trademark—may also affect the reliability of the comparison.

Reliability of Profit Measures
Reliability is an important facet for determining the resale price. The reliability of profit measures that are based on gross profit may be adversely affected by factors that have less effect on prices.34 The reliability of the analysis may be affected in material differences that are identified based on objective evidence. Gross profit may be affected by a variety of other factors, for example:

- Cost structures, reflected, for example, in the age of plant and equipment
- Business experience, such as whether the business is in a start-up phase or is mature
- Management efficiency, as indicated, for example, by expanding or contracting sales or executive compensation over time

Adjustments to Determine the Resale Price
Adjustments should be made if there are material differences between controlled transactions and uncontrolled transactions that affect the gross profit margin.35 These adjustments should be made to the gross profit margin earned from the uncontrolled transactions. The standards of comparability apply, so the adjustments must be based on commercial practices, economic principles, or statistical analyses.

A consideration of the operating expenses that are associated with functions performed and risks assumed may be necessary as part of this adjustment process. This analysis may be needed because differences in functions performed are often reflected in operating expenses.

32 Id.
33 Id.
34 Treas. Reg. §§ 1.482-3(c)(3)(i) and 1.482-3(c)(3)(ii)(B).
The relationship among functions performed, related operating expenses, and gross profit can be complex. The effect on gross profit for the differences in functions performed is not necessarily equal to the differences in the amount of related operating expenses.

Five types of adjustments may be particularly relevant to the resale price method.

1. **Inventory.** Inventory levels and turnover rate may have to be adjusted; correspondingly, business and other risks may have to be adjusted. The presence of price protection programs, such as buy-back programs, are part of this analysis.

2. **Contractual Terms.** The following contract terms may have to be adjusted for:
   - Warranties provided
   - Sales or purchase volume
   - Credit terms
   - Transport terms

3. **Sales, Marketing, Advertising Programs, and Services.** Adjustments must be made for sales, marketing, advertising programs, and services including promotional programs, rebates, and co-op advertising.

4. **The Level of the Market.** The taxpayer may have to adjust for the level of the market, for example, whether retail or wholesale.

5. **Foreign Currency Risks**

### Commission and Buy–Sell Arrangements

A sales agent might receive a commission rather than acquiring and then relinquishing title to the goods or otherwise assuming risks concerning these goods. Sales commissions are treated in the same manner as buy–sell transactions. The comparable gross margin may be used in either situation to determine resale price. The commission earned by the sales agent, expressed as a percentage of the uncontrolled sales price of the goods, may be used as the comparable gross profit margin.

### Accounting Consistency

The resale price method requires that accounting practices be consistent between the controlled transaction and uncontrolled comparables. Absolute accounting consistency is not required. Differences are acceptable so long as the difference is accounted for, but differences in accounting that “materially affect the gross profit margin” affect the reliability of the result. Such differences could include inventory timing and

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41 Treas. Reg. § 1.482-3(c)(3)(ii)(D).
reporting consistency. Differences other than those stated above also may be part of this analysis.

- For example, differences in inventory and other cost accounting practices materially affect the analysis of the gross profit margin. In this event, ability to make reliable adjustments for these differences would affect the reliability of the results.
- The controlled transaction and the uncontrolled comparable should be consistent in the reporting of various items between cost of goods sold and operating expenses. Such items could include:
  - Discounts, returns, and allowances
  - Rebates
  - Transportation costs
  - Insurance
  - Packaging

**Resale Profit Method: Examples**

The transfer pricing regulations provide seven examples of the resale profit method.43

**EXAMPLE 1**

**Computing the Profit Margin**

The first resale profit example explains how the gross margin is determined. A controlled taxpayer sells property to a distributor, also a controlled taxpayer. The distributor in turn resells the property to customers that are uncontrolled taxpayers. The resale price for controlled sale is $100 and the distributor’s gross margin is 20 percent, which (according to the example) was viewed as arm’s-length. The arm’s-length price (the controlled distributor’s sale price and the distributor’s cost) is $80, which is $100 minus 20 percent of the $100 resale price.

The determination of gross margin can be complex for transfer pricing purposes and may require many steps. In this fact pattern, however, the stated gross profit margin of 20 percent can be used directly for transfer pricing purposes without changing the gross profit margin. Here, there are no changes in the beginning inventory and ending inventory for the year under review. Furthermore, the information regarding “an uncontrolled comparable” (not shown in the regulation’s example) is “sufficiently complete” to conclude that it is “likely” that “all material differences” between controlled and uncontrolled transactions have been “identified” and “adjusted for.”

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43 Treas. Reg. § 1.482-3(c)(4).
EXAMPLE 2

Adjustments to the Gross Margin

In the second resale price example, the district director changed the company’s gross margin, which in turn modified the pricing between the producer and the distributor. The district director adjusted the price to property purchased by a distributor.

The taxpayer, S, a U.S. corporation, is the exclusive distributor for FP, its foreign parent. The gross margin is determined in reference to S’s cost of goods sold. There are no changes in the beginning and ending inventory for the year under review. S has a resale price of $1,000 for sales to unrelated parties, and reports a total cost of goods sold of $800, making $200 the reported gross profit. The distributor has two components to determine the cost of goods sold: purchases of $600 from FP and purchases of $200 from unrelated parties.

Applicable resale price $1,000
Cost of goods sold
  Purchases from FP 600
  Purchases from unrelated parties 200
Total cost of goods sold (800)
Reported gross profit 200

The district director rejects the gross profit margin of 20 percent and determines that the appropriate gross margin is 25 percent. (The example does not provide the rationale for this determination on the part of the district director.) S’s gross profit is therefore $250, 25 percent of the $1,000 resale price. The resale price of $1,000 is made to unrelated parties, and the costs of $20 are incurred to unrelated parties, so adjustments have to come from the $800 difference. The taxpayer is to adjust FP’s purchases in computing the appropriate gross margin.

Two steps are needed to determine S’s arm’s-length price from FP. The appropriate gross profit of $250 is subtracted from the resale price of $1,000, leaving a cost balance of $750. The $750 amount is then reduced by the $20 unrelated party cost of sales to arrive at the S’s arm’s-length price of $550. Accordingly, the transfer price has been changed from $600 to $550.

EXAMPLE 3

Determining the Resale Price

The third resale price example describes a situation in which the resale price is based on the ultimate or final sale. The resale price is based on the last sale between a controlled entity and an uncontrolled entity. FP, a foreign manufacturer, sells the product to its U.S. subsidiary, US Sub. US Sub in turn sells the product to its domestic
affiliate, “Sister,” and Sister sells the product to unrelated buyers. In this case, the “applicable sales price” is the price at which Sister sells the product in uncontrolled transactions.

The appropriate gross margin for the sales from FP to US Sub depends upon the functions performed both by US Sub and by Sister. The taxpayer must use functional analysis, taking the relevant factors into account. The functions may have to be segregated between activities of US Sub and that of Sister. Separate amounts may be needed to ascertain the relative income amounts for each party. This analysis might be usable for transfer pricing in the state tax context.

**EXAMPLE 4**

**Making Accounting Classifications**

The fourth resale price example indicates how the method depends upon accounting reclassifications. Here, US Sub, a U.S. corporation, is the exclusive distributor of widgets for its foreign parent. The district director considers applying the resale price method to determine whether the gross profit margin of 25 percent earned by US Sub is arm’s length. Several uncontrolled distributors perform “similar functions” under “similar circumstances” in uncontrolled transactions; however, the accounting procedures for the uncontrolled distributors differ from those of US Sub. The uncontrolled distributors treat certain costs, such as discounts and insurance, as cost of goods sold; US Sub treats discounts and insurance as operating expenses.

Accounting methods should be consistent between the controlled distributor and the uncontrolled distributor. Reclassification must be made to the accounting data of the uncontrolled parties to ensure consistent treatment of material items. Nevertheless, making such accounting reclassifications might not be mandatory. Failure to make accounting reclassifications does preclude the use of the resale price method per se; instead, the inability to make such accounting classifications will decrease the reliability of the results of the uncontrolled transactions. As a result, failure to reclassify the accounting data may mean that the resale price method may not be the best transfer pricing method.

**EXAMPLE 5**

**Uncontrolled Distributors, Competing Products**

The fifth resale price example illustrates how information from uncontrolled distributors establish an arm’s-length range. Here, we focus on a foreign distributor that is owned by a U.S. parent in applying the resale price method.

USP, a U.S. corporation, manufactures Product X, an unbranded widget. USP sells Product X to F Sub, its wholly owned foreign subsidiary. F Sub is a distributor of Product X in country M, selling Product X to uncontrolled parties in that country.

Five uncontrolled distributors, A, B, C, D, and E, distribute competing products in country M, and all such products are unbranded and of similar value to those of
F Sub. The distribution activities of F Sub and its competitors determine the resale price. The following five items are present for purposes of applying the resale price method:

1. “Relatively complete data” are available regarding:
   - The functions performed by the uncontrolled distributors
   - The risks borne by the uncontrolled distributors
   - The contractual terms under which uncontrolled distributors operate in uncontrolled transactions
2. Data is available to ensure accounting consistency between all the uncontrolled distributors and F Sub.
3. The available data is “sufficiently complete and accurate” to conclude that it is “likely” that “all material differences” between controlled and uncontrolled transactions have been identified.
4. Such differences have a “definite and reasonably ascertainable” effect.
5. “Reliable” adjustments are made to account for the aforementioned differences.

Because all of the preceding five factors are present, the results of each of the uncontrolled distributors can be used to determine an arm’s-length range.

**EXAMPLE 6**

**Uncontrolled Distributors, Insufficient Data**

This resale price example presents the same facts as those in Example 5, except that the available data is insufficient. Data is not available to determine whether any of the controlled distributors provide warranties, and data is not available to determine the distributor’s payment terms. These differences in contractual terms may materially affect price or profits. The taxpayer is unable to determine whether these differences exist, and reliability of the results is diminished; however, the taxpayer can enhance the results by truncating the database.

**EXAMPLE 7**

**Trademarks and the Resale Price Method**

The seventh resale price example illustrates the impact of valuable trademarks on the selection of competing products for transfer pricing purposes. The facts for this example are the same as for Example 5, except that Product X is branded with a valuable trademark that is owned by P (or USP in Example 5).

Because Product X is branded, we must turn our attention to P’s competitors. A, B, and C distribute unbranded competing products. By contrast, D and E distribute products branded with other trademarks. P owns the valuable trademark for Prod-
uct X. In contrast, D and E do not own any rights in the trademarks under which their products are sold.

The fact pattern indicates that the value of the products sold by A, B, and C are not similar to the value of the products sold by S (referred to as F Sub in Example 5). The value of the products sold by D and E is similar to the value of Product X.

Close product similarity is not as important for a reliable application of the resale price method as it is for the comparable uncontrolled price method; however, despite the limited importance of close product similarity, significant differences in the value of the controlled and uncontrolled products may affect the reliability of the results.

In this situation, it is difficult to determine the effect that trademark will have on price or profits. As a result, reliable adjustments cannot be made for the differences in the trademark. D and E are more comparable to S than are A, B, and C to S. Thus, only D and E may be included in the arm’s-length range.

**COST-PLUS METHOD**

The cost-plus transfer pricing method combines the costs incurred to produce the property with the gross profit markup from the costs.\(^{44}\) The amount charged in a controlled transaction is compared with comparable uncontrolled transactions in evaluating whether the gross profit markup is arm’s length. The gross profit is computed by multiplying the controlled taxpayer’s cost of producing the transferred property by the gross profit markup.\(^{45}\) The appropriate gross profit is expressed as a percentage of cost.\(^{46}\)

The cost-plus method may be the best method if the producer provides more complete data than does the distributor. This method is ordinarily used for the manufacture, assembly, or other production of goods that are sold to related parties.\(^ {47}\)

The procedure for the cost-plus method, like the procedure for the resale price method, requires comparability between the controlled party and the uncontrolled party. The procedure necessitates an analysis of functional comparability and other comparability factors.\(^ {48}\) Then, the taxpayer adjusts differences between controlled and uncontrolled transactions. Consistency in accounting is required.

**Functional Comparability**

The general facets of comparability apply to the cost-plus method, including functions, contract terms, risks, economic conditions, and property or services. As a general precept, a producer’s gross profit is designed to provide the producer with compensation for performing production functions as to the product or products

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\(^{44}\) Treas. Reg. § 1.482-3(d).
\(^{45}\) Treas. Reg. § 1.482-3(d)(2)(i).
\(^{46}\) Treas. Reg. § 1.482-3(d)(2)(ii).
\(^{47}\) Treas. Reg. § 1.482-3(d)(1).
under review. This gross profit is to include an operating profit for the producer’s investment in capital and for the assumption of risks. Some of the five factors are more important than others in applying the cost-plus method. Comparability under this method is particularly dependent on three factors: functions performed, risks borne, and contractual terms. Adjustments can be made to account for the effects of the differences between controlled transactions and uncontrolled transactions.

Comparisons of transactions are an essential ingredient in applying the cost-plus method. This comparison can take place between sales of the taxpayer to an uncontrolled entity or between two unrelated entities. The regulations permit and even encourage the use of in-house comparables and prefer that the comparison take place between the taxpayer and an uncontrolled entity.

If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale. The taxpayer’s sales are preferred because similar characteristics are more likely to be found from the sales of the same producer than from sales by other producers. A taxpayer can use wholly independent entities if the taxpayer’s sales are not available. In that situation, the taxpayer determines an appropriate gross profit market markup using comparable uncontrolled sales of other producers. The other producers might or might not be members of the same controlled group.

Other Comparability Factors

Comparability under the cost-plus method is particularly dependent on functions performed, risks borne, and contractual terms. Comparability under the cost-plus method is less dependent on “close physical similarity” between the products transferred than under the comparable uncontrolled price method. Product differences are permitted, but within limits, in applying the cost-plus method. Substantial product differences tend to indicate functional differences. As a result, it is to be expected that the comparative transactions would involve production of goods within “the same product categories.” Significant differences in the product may affect the reliability of the comparison. Differences in the value of the trademark are such a difference.

The reliability of profit measures that are based on gross profit may be adversely affected by factors that have less effect on prices, such as:

- **Cost structures.** The age of plant and equipment
- **Business experience.** Whether the business is in a start-up phase or is mature
- **Management efficiency.** As indicated by expanding or contracting sales, or by executive compensation over time

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49 *Id.*


53 *Id.*

54 *Id.*
Reliability of the analysis may be affected by material differences in the preceding factors.

**Adjustments for the Differences**

Adjustments can be made under the cost-plus method for the differences between controlled transactions and uncontrolled transactions.\(^5\) Differences are material if they affect the gross profit markup. Adjustments should be made to the gross profit earned in comparable uncontrolled transactions.

The adjustment process reflects operating expenses associated with the functions performed and with the risks assumed. Differences in functions performed are often reflected in operating expenses.\(^6\) The effect on gross profit on functional differences is not necessarily equal to the differences in related operating expenses.

The following factors could be especially relevant to the cost-plus methods:\(^7\)

- The complexity of the manufacturing process or of the assembly operations
- Manufacturing, production, and process engineering
- The extent of the procurement, purchasing, and inventory control activities
- The testing functions
- Selling, general, and administrative expenses
- Foreign currency risks
- Contract terms—such as the scope and terms of warranties provided, the volume of sales or purchases, credit terms, and transport terms

**Purchasing Agent**

A purchasing agent that buys the item or receives a commission is treated in the same manner for purposes of cost-plus pricing. The commission earned by the purchasing agent is expressed as a percentage of the purchase price of the goods. This purchase price percentage may be used as the appropriate gross profit markup.\(^8\)

**Consistency in Accounting**

The cost-plus method requires consistency in accounting. The degree of consistency in accounting practices affects the reliability of the result. Reliability depends on the completeness and accuracy of the data and the reliability of the assumptions.\(^9\)

Consistency between the controlled transaction and the uncontrolled comparables focuses on “comparables that materially affect the gross profit margin.” Adjustments must be determined in an organized manner because differences in inventory and other cost accounting practices might materially affect the gross profit markup. The comparison between the controlled transaction and the uncontrolled transaction

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\(^6\) Id.
\(^7\) Id.
\(^8\) Treas. Reg. § 1.482-3(d)(3)(ii)(D).
may be more or less reliable, depending on the taxpayer’s ability to make reliable adjustments.\textsuperscript{60}

The taxpayer should maintain consistency in accounting. The controlled transaction and the comparable uncontrolled transaction should be consistent in reporting costs. This consistency in accounting includes reporting costs between cost of goods sold and operating expenses. The term “cost of producing” includes the cost of acquiring property that is held for resale.\textsuperscript{61}

The cost-plus regulations do not specifically refer to the uniform capitalization provisions. Instead, the overall tenor of the transfer pricing regulations is that the comparison of accounting data between the controlled transaction and the uncontrolled comparable would be consistent. In this example, we are assuming that the uniform capitalization rules in fact apply to the controlled transaction. Thus the uniform capitalization rules would normally apply to U.S. transactions if the comparison is to uncontrolled transactions in the United States.

**Cost-Plus Method: Examples**

Four examples illustrate the use of the cost-plus method.\textsuperscript{62} The same fact pattern is used in the first three examples.

**EXAMPLE 1**

**Transactions With Relatively Complete Data**

The first cost-plus example describes a situation in which USP, a domestic manufacturer of computer components, sells its products (the components) to FS, its foreign distributor. The distributor is presumably independent from the foreign manufacturer of the computers, but the example does not directly address this point. USP has three competitors, UT1, UT2, and UT3, who are domestic computer component manufacturers that sell components to uncontrolled foreign purchases.

The example then turns its attention to the unrelated parties (UT1, UT2, and UT3) who sell to uncontrolled foreign purchasers. There was no discussion of any sales by USP to another distributor apart from USP’s sales to FS, so it is safe to say that such transactions did not take place. If such sales did take place, data from these sales would have been preferable.

“Relatively complete data” is available concerning UT1, UT2, and UT3. These data, which are not specified in the regulations, pertain to the functions performed by each of the three entities. The data, again not specified in the regulations, include the risks borne by each party, together with the contractual terms that each party uses in the uncontrolled transactions. This example appears too far removed from reality. In addition, data in the example is to be available to ensure accounting con-

\textsuperscript{60} Id.

\textsuperscript{61} Id.

\textsuperscript{62} Treas. Reg. § 1.482-3(d)(4).
sistency between “all of the uncontrolled manufacturers and USP.” The regulations do not tell us how we could obtain accounting data either.

The example concludes that USP can use the arm’s-length range, which is not truncated. The taxpayer is able to use the broadened range for the following reasons:

- The data is sufficiently complete.
- It is likely that all material differences between the controlled and uncontrolled transactions are identified.
- The effects of the differences are definite and reasonably ascertainable.
- Reliable adjustments are made to account for the differences.

**EXAMPLE 2**

**Accounting Consistency**

The facts in the second cost-plus example are the same as in the first example, except for accounting differences. USP accounts for supervisory, general, and administrative costs as operating expenses. These costs are not allocated to FS. By contrast, the supervisory, general, and administrative costs incurred by UT1, UT2, and UT3 are accounted for as cost of goods sold. USP and the three competitors will have a different gross profit markup.

The gross profit markups of UT1, UT2, and UT3 must be adjusted for the difference in the treatment of general, supervisory, and administrative costs to provide for accounting consistency. Reliability of the results will be decreased if the adjustments are not made or if the data is not sufficient to determine whether such accounting differences exist. The unstated conclusion is that making adjustments to the data may make the cost-plus method the best method; not making adjustments may cause the cost-plus method not to be the best method.

**EXAMPLE 3**

**Purchasing or Consignment**

The third cost-plus example has the same facts as in Example 1, except that inventories are treated in a different manner. The contract between USP and FS provides that FS owns the computer components. FS consigns the materials to USP; USP produces the items. USP’s competitors, UT1, UT2, and UT3, purchase their own materials in making computer components. The inventory status between USP and its competitors differ, and gross profit markups differ correspondingly.

USP did not purchase its own materials and does not carry an inventory risk. Its competitors, the uncontrolled producers UT1, UT2, and UT3, carry inventory. The difference between the companies as to inventory is a significant difference. The inventory difference may require an adjustment if the difference has a material effect on gross profit markups.
USP may be able to ascertain the effect of the difference on gross profit markups, which may mean that the cost-plus method is the best method. On the other hand, inability to reasonably ascertain the effect of the difference on the gross profit markup will affect the reliability of the results.

**EXAMPLE 4**

**Applying the Truncated Range**

The fourth cost-plus example illustrates the use of a truncated range when sufficient data is not available. Here, the U.S. parent corporation, USP, owns a subsidiary, FS, which produces apparel for USP. FS purchases its materials from unrelated suppliers and produces the apparel according to designs provided by USP.

After audit, the district director identifies 10 uncontrolled foreign apparel producers that operate in the “same geographic market” and are “similar in many respects” to FS. The IRS then reviewed the quality of USP’s data and determined that the data is “relatively complete.” USP has acquired data concerning the functions performed and risks borne by the uncontrolled producers. In addition, the data is “sufficiently detailed” to permit adjustments in accounting practice.

There is a gap in USP’s database, however. The IRS determined that data is not available to determine whether all material differences in contractual terms have been identified. As part of this gap, for example, it is not possible to determine which parties in the uncontrolled transaction bear the currency risk.

Differences in contractual terms could materially affect price or profits. As a result, the inability to determine whether differences exist between controlled transactions and uncontrolled transactions will diminish the reliability of the results. Nevertheless, the cost-plus method may be acceptable under the best method rule. Reliability of the results must be enhanced by truncating the range, whether by using a statistical method or otherwise.

**CONCLUSION**

The regulations permit—and even encourage—the use of in-house comparables in ascertaining the resale price method and the cost-plus method.63 As a result, most companies will be able to use either of these two methods in complying with the best method requirements. The comparable uncontrolled price method can be used in limited situations. The comparable profits method, the profit-split method, or unspecified methods will be the best method in unusual and complex fact patterns when there are no in-house comparables.

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The comparable profits method (CPM) is a pricing method that applies to inter-company transfers of both tangible and intangible property. The CPM applies objective measures of profitability, called “profit-level indicators,” in determining the arm’s-length price. The indicators are derived from uncontrolled companies that engage in similar business activities under similar circumstances. These profit-level indicators apply to the controlled transactions of the tested party. CPMs of similarly situated taxpayers tend to earn similar returns over a reasonable period of time.

NO SAFE HARBOR

The CPM is not a safe harbor, even for U.S. purposes. Other transfer pricing methods, particularly the transaction methods, achieve a higher degree of comparability than does the CPM, given adequate data. The Preamble to the regulations states:

Because the degree of comparability, including the extent and reliability of adjustments, determines the relative reliability of the result under the best method rule, the results of these methods will be selected unless the data necessary to apply them is relatively incomplete or unreliable. In this regard, the CPM generally would be considered a method of last resort.

BEST METHOD RULE

The CPM might be the best method under the facts and circumstances of a transaction. The “best method” rule specifies that an arm’s-length result must be determined under the method that, given the facts and circumstances, provides the “most accurate measure” of an arm’s-length result. Two primary factors that determine the best method are comparability and quality of data,¹ both of which affect the potential for a CPM as the best method.

Identical transactions under identical circumstances will provide the most accurate measure of an arm’s-length price. Such data is rarely available, especially so for

¹ Treas. Reg. § 1.482-1(c)(2).
intangible property, so that the regulations allow the use of uncontrolled transactions that are comparable to, rather than identical with, the controlled transactions. Adjustments must be made for differences if reliability of the analysis is to be achieved.

COMPARABLE PROFITS METHOD

The profit-level indicator applies one or more ratios in achieving arm’s-length results. The resulting amount is the amount that the “tested party” would have earned on related-party transactions if its profit level were equal to that of an uncontrolled comparable party. One or more profit-level indicators (e.g., net profit as a percentage of sales) is chosen from the third-party transactions to compare to the financial data of the tested party’s most narrowly identifiable business activity. This activity is the “relevant business activity” for which data incorporating the controlled transaction are available. The tested party’s reported operating profit has achieved an arm’s-length result if a similar result is obtained when compared to the operating profit of the uncontrolled comparable.²

Operating Profit

An essential component in determining CPM is often “operating profit.” Operating profit is gross profit less operating expenses. Operating profit includes all income derived from the business segment being evaluated but does not include the following:

- Interest
- Dividends
- Profits derived from unrelated activities
- Extraordinary gains and losses that do not relate to the continuing operations of the tested party³

Tested Party

The first step in the CPM process is to select the “tested party.” The tested party is the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified. The company provides the most reliable data and requires the fewest and most reliable adjustments. Reliable data regarding uncontrolled comparables must be located.⁴ Several participants in a controlled group may be able to qualify as the tested party. The tested party is not the owner of valuable intangible property or unique assets that prevent it from being comparable to an uncontrolled comparable.⁵

² Treas. Reg. § 1.482-5(b)(1).
⁴ Treas. Reg. § 1.482-5(b)(2).
⁵ Id.
Arm’s-Length Range

An arm’s-length range applies to all transfer pricing methods. There could be a range of CUPs, a range of arm’s-length markups in applying a resale price method, or a range in computing the cost-plus method. A range of profit levels, in applying the CPM, represents an acceptable third-party standard.

The taxpayer must determine the uncontrolled comparables for all transfer pricing methods. Although it would ultimately be preferable to find identical comparables, this is just not going to happen. Similar comparables are more likely to be available. Information on the controlled and uncontrolled transactions must be sufficiently complete so that it is likely that all material differences can be identified and adjustments can be made to account for all differences that have a definite and reasonably identifiable effect on price or profits.

The arm’s-length range may have to be readjusted, as where the taxpayer constructs an arm’s-length range using similar comparables, but some but not all material differences were accounted for through adjustments. In this situation, the range must be adjusted through the application of a valid statistical method, if possible, to increase the reliability of the analysis.\(^6\) This reliability test is satisfied if statistical methods apply to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range.\(^7\) The interquartile range will satisfy the reliability test. The interquartile range is the range from the 25th to the 75 percentile of the results derived from the uncontrolled transaction (i.e., the middle 50 percent).\(^8\)

The District Director may make adjustments to a controlled transaction if the results fall outside the arm’s-length range. If the Section 482 adjustment is made in accordance with the interquartile range, the adjustment will ordinarily be to the median, or 50th percentile, of the results. In other cases, the adjustment ordinarily will be made to the arithmetic mean of the results.\(^9\) Whatever transfer pricing method the taxpayer uses, the District Director may make adjustments under another method, in that situation. No adjustment will be made if the taxpayer can show that its results are within the range established by equally reliable uncontrolled prices.\(^10\)

Profit-Level Indicators

Profit-level indicators are ratios that measure relationships between profits with costs or resources. A specific profit-level indicator is selected if it is likely to produce a reliable measure of income. Profit-level indicators are “generally” derived from the year under review and the two prior taxable years.\(^11\)

\(^7\) Treas. Reg. § 1.482-1(e)(2)(iii)(B).
\(^8\) Treas. Reg. § 1.482-1(e)(2)(iii)(C).
\(^9\) Treas. Reg. § 1.482-1(e)(3).
\(^10\) Treas. Reg. § 1.482-1(e)(4).
The regulations list two types of profit-level indicators, but this list is not exclusive. The first profit-level indicator is rate of return on capital employed, the ratio of operating profit to operating assets. This profit-level indicator applies where operating assets generate most of the profit for the tested party and controlled comparable. Operating assets are the value of all assets used in the relevant business activity. Such assets include fixed assets and current assets, such as cash, cash equivalents, and accounts receivable and inventories. Operating assets do not include investment in subsidiaries, excess cash, or portfolio investment.

Operating assets may be measured by book value or by fair market value, but the method of selecting value must be consistently applied. Adjustment may have to be made, for example, for leased assets, acquisitions, or currency fluctuations. The value of the items of operating assets is the average value of the assets taken into account at both the beginning and the end of the year.

The CPM may be computed by using financial ratios between profit, costs, or sales revenue. Closer comparability is required when using financial ratios because of greater interdependence between the elements used to calculate results. Two financial ratios are suggested, but are not exclusive:

1. Ratio of operating profits to sales
2. Ratio of gross profit to operating expenses

Sales are the amount of total receipts from the sale of goods and services, less returns and allowances. The taxpayer must use generally accepted accounting practices for that trade or industry. Operating expenses include all expenses not included in the cost of goods sold, except for interest expense, taxes, and expenses unrelated to the operation of the relevant business activity. Operating expenses ordinarily include marketing expenses, warehousing and distribution, administrative expenses, and depreciation and amortization.

**COMPARABILITY**

The CPM must be calculated in accordance with general standards of comparability. The CPM provides some specific rules.

**General Principles of Comparability**

Two transactions are considered comparable if the uncontrolled transaction provides a reliable measure of an arm’s-length result in the controlled transaction. Adjustments must be made for material differences if the effect of the differences can be
ascertained with sufficient accuracy to improve the reliability of the result. If adjustments cannot be made, the uncontrolled transaction is not considered comparable. A “material difference” is one that would materially affect price or profit.  

Five factors affect comparability:

1. Functions
2. Contractual terms
3. Risks
4. Economic conditions
5. Similarity of property or services

Transactions are not considered to be comparable if the transactions are not in the ordinary course of business or are transactions arranged with a principal purpose of establishing an arm’s-length result. The ordinary course of business requirement is designed to prevent taxpayers from entering into uncontrolled transactions without true economic substance to justify its intercompany pricing, or entering into a de minimis number of uncontrolled transactions for the same purpose. This regulation is not intended to prevent taxpayers from entering into true arm’s-length transactions to justify intercompany pricing that is also economically sound. Adjustments may have to be made in the controlled circumstances even where the uncontrolled transaction has economic substance (e.g., for volume discounts), or if intangible property is involved, compensating the party that bore the cost of research and development of each item of intangible property.

**Comparability under the CPM**

The CPM compares the profit of the tested party, raising a profit-level indicator to the profitability of uncontrolled taxpayers in similar circumstances. The CPM relies on external market benchmarks. The CPM process is a facts and circumstances analysis, which requires a view of various aspects of the operation, including the following:

- Relevant lines of business
- The product or service
- Assets employed (e.g., tangible and intangible property)
- Size and scope of operations
- The stage in the business or product cycle

Operating profit is a return for the investment of resources and assumption of risks. Functional risk and resource comparability are the most important, but all fac-

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19 Id.
20 Treas. Reg. § 1.482-1(d)(3).
22 Treas. Reg. § 1.482-5(c)(2).
tors must be considered in determining comparability under all transfer pricing methods, including the CPM. The degree of required functional comparability is less under the CPM than under other methods, such as resale price or cost plus. Differences in functions are reflected in differences in operating expenses, resulting in different levels of gross profit, but similar levels of operating profit. Product similarity may not be of critical importance but, for example, operating profits may be affected by varying cost structures, such as the age of plant and equipment or whether the business is mature or in the start-up stage.

Adjustments are required to account for material differences. In some cases, this adjustment will require a further adjustment to the operating profit attributable to the assets of an uncontrolled transaction. It may be appropriate to adjust the operating profit of the tested party as well as the uncontrolled transaction. This type of adjustment could arise, for example, if there were material differences in accounts payable.

**Data and Assumptions**

Quality of data and assumptions are factors in the reliability of the CPM. Two requirements apply:

1. There must be consistency in accounting. Differences in inventory and cost practices, for example, that materially affect operating profit must be accounted for through appropriate adjustments.
2. The reliability of allocation of costs, income, and assets between the relevant business activity will affect profit-level indicators of the relevant business segment. A preference for a direct allocation is indicated, but the regulations permit use of a “reasonable allocation formula.” For example, if the relevant business activity is the assembly of component parts purchased from controlled and uncontrolled suppliers, it may not be possible to apply a profit-level indicator solely to financial data related to the controlled transactions. Allocation will affect the reliability of the data.

**CPM EXAMPLES**

The regulations contain six examples of the CPM.

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28 Id.
29 Treas. Reg. § 1.482-5(e).
EXAMPLE 1

Interquartile Range with No Adjustments

The first example in the regulations illustrates a transfer of tangible property that causes no adjustment. FP is a foreign publicly traded corporation having USS as a U.S. subsidiary. USS is under audit for 1996. FP manufactures a consumer product for worldwide distribution. USS acts as FP’s U.S. distributor at the wholesale level for the finished product.

FP does not allow unrelated parties to distribute its product. There are no uncon­trolled transactions, but similar products are produced by other companies.

The District Director determines that the CPM is the appropriate transfer pricing method, and that USS should be the tested party because it engages in the least complex functions. These are data from a number of independent operators of wholesale businesses. The transactions selected are those from the same industry segment that performs similar functions and has similar risks to USS. The available information indicates that the ratio of operating profit to sales is the most reliable profit-level indicator. After adjustments to account for some, but not all, material differences, this ratio is calculated for each uncontrolled transaction; however, the data is not sufficiently complete such that it is likely that all material differences have been identified. Therefore, USS is required to use the interquartile range. Because the company’s prices are within the interquartile range, no adjustment is made.

EXAMPLE 2

Adjustments to the Interquartile Range

In the second example, the facts are the same as in the first, but USS’s average operating profit for the years 1994–1996 is $0 and falls outside the range. The year under examination is 1996. An adjustment is made to the median of the interquartile range. The amount of the adjustment for 1996 is based on the difference between USS’s reported operating profit and the median for 1996 for the uncontrolled transactions.

EXAMPLE 3

Multiple-Year Analysis

The third example is the same as in the prior example, but a multiple-year analysis is made to establish the appropriate 1997 profit level. The interquartile range of comparable operating profit for the years 1995–1996 ranges from $15,000–$30,000. USS’s reported operating profit for those years is compared, but without regard to the adjustment made for 1996. USS’s average reported operating profit showed a loss of $10,000 for those years. The median of comparable operating profits for those years for uncontrolled comparables was $12,000. USS’s income for 1997 is increased
by $22,000, the amount necessary to report an operating profit of $12,000 ($10,000 loss, plus $12,000).

**EXAMPLE 4**

**Intangible Property**

The fourth example illustrates the transfer of intangible property to an offshore manufacturer. DevCo is a U.S. developer, producer, and marketer of widgets and has developed a high-tech widget (HTW). HTW is manufactured by DevCo’s foreign subsidiary, ManuCo. ManuCo sells the HTW to MarkCo, a U.S. subsidiary of DevCo for distribution and marketing. ManuCo pays a 5 percent royalty to DevCo. The year 1996 is under audit.

The District Director selects ManuCo as the tested party and determines that the CPM is the most appropriate transfer pricing method. ManuCo engages in relatively routine marketing activities, while DevCo has valuable and unique activities and engages in relatively complex activities. Because ManuCo is a manufacturer, the ratio of operating profits to operating assets is selected as the appropriate profit-level indicator.

Uncontrolled foreign taxpayers performing similar functions occur outside the foreign country in which ManuCo is located. Although data is available to make most of the required material adjustments, it is not likely that there will be absolutely no material differences after the adjustment process. Separately, it is determined that the price ManuCo charges MarkCo is arm’s length.

The interquartile range of profits derived from uncontrolled comparables for 1994–1996 is $3,000 to $4,500. ManuCo’s reported operating profit for these years is $21,500, which falls far outside the range. ManuCo’s operating profit for 1996 was $25,250. The median for uncontrolled comparables was $3,750. The royalties ManuCo paid DevCo in 1996 are increased by $21,500 (the difference between $25,250 and the median of comparable operating profit of $3,750).

**EXAMPLE 5**

**Differences in Accounts Receivable**

The fifth example illustrates adjustments to operating assets and operating profits for differences in accounts receivable. USM is a U.S. company that manufactures parts for its foreign parent. Fifteen uncontrolled manufacturers have been identified, and USM has a significantly lower level of accounts receivable. The rate of return on capital employed is utilized as the profit-level indicator. Operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled operating asset is reduced by the amount, relative to sales by which they exceed USM’s accounts receivable. Uncontrolled operating profit is adjusted by deducting imputed interest income on excess accounts receivable. Imputed interest income is calculated
by multiplying the accounts payable by an interest rate appropriate for short-term debt.

**EXAMPLE 6**

**Differences in Accounts Payable**
The last example illustrates adjusting operating profit for differences in accounts payable. USD is the U.S. distributor for its foreign parent. Ten uncontrolled similar distributors are identified. To adjust for significant differences in accounts payable between the controlled and uncontrolled transactions, the operating profit of both is decreased to reflect imputed interest expense. Imputed interest expense is calculated by multiplying the accounts payable by an interest rate appropriate for short-term debt.

**CONCLUSION**
The CPM appears to meet third-party criteria, but it fails because it is based on ranges of profitability. The arm’s-length standard has been in use for many years based on the price (or margin) that a willing seller would accept from a willing buyer. Ranges of profitability are affected by a multitude of factors: competitive position, management efficiency, business cycles in the industry and on a global basis, currency fluctuations, age of plant and equipment, intangible property, research and development, cost of capital, marketing efficiency, and so forth. These considerations, although they may ultimately affect price, are not factors in determining a price in an arm’s-length transaction. The arm’s-length standard looks to transactions, not ranges of profitability.
The transfer pricing provisions\(^1\) regulate, for tax purposes, the amount charged in a “controlled transfer”\(^2\) of “intangible property.”\(^3\) This transfer pricing amount is to be at “arm’s length.”\(^4\) All of these are technical tax terms. The arm’s-length transfer for the intangible must be “commensurate with the income attributable to the intangible.”\(^5\) This analysis focuses on the current transfer pricing regulations, promulgated on July 8, 1994, which reflect the extensive changes to the prior regulations emanating from both the statutory changes and the regulatory process.\(^6\) This analysis focuses on the comparable uncontrolled transaction method and its exceptions.\(^7\)

Royalties paid to affiliated companies are subject to special scrutiny by the Internal Revenue Service. The pervasive nature of the royalties can be seen from the following examples:

**EXAMPLE 1**

A closely held well-known and long-established company uses the surname of the founder, an uncommon name. The company protects its name from copycat companies by filing appropriate registration statements with the Department of State’s cor-
poration unit in each jurisdiction. The company allows one of the scions of the family to set up a separate corporation that uses the well-known name and to do so without any payment to the company for the use of the name. The IRS could claim that the closely held company transferred an intangible, the use of the well-known name, and could determine the value of the intangible transferred as a royalty. A similar situation could arise as to a transfer of trademarks, trade names, trade dress, and the like.

**EXAMPLE 2**

A domestic company develops a secret process that it uses in producing its products. This company sets up a foreign company, and technicians from the parent company assist the foreign company in implementing the production process overseas. The IRS could claim that the domestic company transferred an intangible, the secret process, and could determine the value of the intangible transferred as a royalty. The transaction could be subject to international reorganization rules and to additional customs duties if the products are imported into the United States.

**EXAMPLE 3**

A foreign closely held company prepared an extensive survey, study, and forecast of the U.S. market. An adult child of the foreign owner moves to the United States to implement the survey, study, and forecast. With proper structuring, this child may be able to deduct royalty payments made to the foreign company for the use of the survey, study, and forecast.

**GENERAL PRINCIPLES AND GUIDELINES**

The transfer pricing regulations require the use of “general principles and guidelines” to determine the transfer price of intangible property. These principles and guidelines are comprehensive and apply to all types of transfer pricing, including sales of tangible property and services, in addition to intangible property. The implementation of the transfer pricing methodologies necessitates compliance with the following three specific facets of the general principles and guidelines:

1. The best method rule
2. The comparability analysis
3. The arm’s-length range

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8 Treas. Reg. § 1.482-1(a)(1).
9 Treas. Reg. §§ 1.482-1(c) and 1.482-4(a).
10 Treas. Reg. §§ 1.482-1(d) and 1.482-4(a).
11 Treas. Reg. §§ 1.482-1(e) and 1.482-4(a).
The comparability analysis is the most pervasive of the three requirements, as it necessitates a comparison of functions, contract terms, risks, economic conditions, and property or services. This analysis, in and of itself, does not determine the transfer pricing method. In fact, certain transfer pricing methods devote more attention to comparability than do other transfer pricing methods. For example, the comparable uncontrolled transaction method for intangibles relies heavily on contract terms and economic conditions to determine comparability, whereas other methods downplay these factors.

**ELIGIBLE METHODS**

The transfer pricing regulations specify that the transfer pricing amount must be determined under one of four methods:

1. The comparable uncontrolled transaction method
2. The comparable profits method
3. The profit split method
4. Unspecified methods

The first three methods enumerated here comprise detailed and complex requirements, the first of which is the subject of this chapter. The fourth alternative is all-encompassing, a catch-all provision for transactions that do not comply with the requirements for the first three methods. The comparable uncontrolled transaction method applies specifically to the transfer of intangibles and does not apply to other transfers. This method is similar, but not identical, to the comparable uncontrolled price method for tangible property. By contrast, the comparable profits method and the profit split method can be used for the transfer of both tangible and intangible property.

**“INTANGIBLE” AND ITS DEFINITIONS**

The transfer pricing regulations define “intangible” as an “asset” that falls into any of six categories of assets and has “substantial value” independent of serv-

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12 Treas. Reg. § 1.482-1(d)(1).
14 Treas. Reg. § 1.482-4(a).
16 Treas. Reg. § 1.482-4(a)(2).
17 Treas. Reg. § 1.482-4(a)(3).
19 Treas. Reg. § 1.482-3(b).
20 Treas. Reg. § 1.482-4(b).
21 Id.
Substantial value is not defined in the intangibility regulations. The six categories can be expressed as follows:

1. **Technology**
   - Patents
   - Inventions
   - Formulas
   - Processes
   - Designs
   - Patterns
   - Know-how

2. **Literary**
   - Copyrights
   - Literary compositions
   - Musical compositions
   - Artistic compositions

3. **Sales**
   - Trademarks
   - Trade names
   - Brand names

4. **Business organizations**
   - Franchises
   - Licenses
   - Contracts

5. **Operations and lists**
   - Methods
   - Programs
   - Systems
   - Procedures
   - Campaigns
   - Surveys
   - Studies
   - Forecasts
   - Estimates

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Id.

23 Treas. Reg. § 1.482-4(b)(1).

24 Treas. Reg. § 1.482-4(b)(2).


27 Treas. Reg. § 1.482-4(b)(5).
6. Other similar items

An item is “similar” to the items on the preceding list of intangibles if the item derives its value from its “intellectual content” or from other intangible properties. Also, an item is considered an intangible in the “other similar items” category if the value of the item is not derived from its physical attributes.

The current definition of “intangible property” is similar to the definition of intangibles in the 1968 regulations and in the 1993 temporary transfer pricing regulations; However, the drafters of the 1994 regulations removed the phrase “commercially transferable” from the 1993 transfer pricing regulations, viewing this provision as superfluous. The preamble to the 1994 regulations states that if the property were not commercially transferable, it “could not be transferred” in a controlled transaction. The drafters of the preamble have overstated the case, as the property could be transferred even if commercial viability was not present. The regulations clarify the reference to “other similar items” as meaning items that derive their value from intellectual content or from other intangible properties rather than from physical attributes.

COMPARABLE UNCONTROLLED TRANSACTION METHOD

The comparable uncontrolled transaction method uses the comparability of the transactions to achieve arm’s-length results. More specifically, the comparable uncontrolled transaction method determines an arm’s-length royalty for an intangible by reference to uncontrolled transfers of “comparable intangible property” under “comparable circumstances.” Thus the comparable uncontrolled transaction method requires both comparability of the transactions and an arm’s-length range for the results. Comparability of the transactions requires:

- The application of “best method” factors
- “Reliability” of the transactions

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28 Treas. Reg. § 1.482-4(b)(6).
29 Id.
30 Id.
31 Id.
33 Preamble for Treas. Reg. § 1.482-4.
34 Id.
35 Treas. Reg. § 1.482-4(b)(6).
37 Preamble for Treas. Reg. § 1.482-4; Treas. Reg. § 1.482-4(c)(1).
38 Treas. Reg. § 1.482-4(c)(2).
40 Treas. Reg. § 1.482-4(c)(2)(ii).
Compliance with more detailed comparability requirements, including the use of “comparable intangible property” and “comparable circumstances”\(^41\)

The latter two terms are discussed later in this chapter.

The “profit potential”\(^42\) of the intangibles is an important factor under the comparable uncontrolled transaction method. The profit potential of the intangibles for the controlled transactions is compared to the profit potential for uncontrolled transactions. The profit potential from the intangibles need not be “substantially the same.”\(^43\) The 1993 temporary regulations had imposed the profit potential requirement, but this provision was relaxed in the 1994 regulations to permit frequent use of the comparable uncontrolled transaction method.\(^44\) Nevertheless, the comparable uncontrolled transaction method must provide the “most reliable measure” of an arm’s-length result under the best method rule.\(^45\) Additionally, the regulations expanded the comparability factors under the comparative uncontrolled transaction method and for all methods in general.\(^46\)

The following three examples illustrate the CUT method.

**EXAMPLE 1**

Company X licenses its technology to Company Y, a related company, and to Company Z, an unrelated company. The circumstances affecting Companies Y and Z are identical, as are the license terms. The license to Company Z provides for a royalty of 3 percent of sales. This royalty determine whether the license to Company Y is at arm’s length. The CUT method also applies to related transactions that are similar to unrelated transactions but are not quite comparable.

**EXAMPLE 2**

The facts are the same as in the prior example, except that Company Z has to incur marketing efforts equal to 1 percent of sales. The royalties between Company Y and Company Z can be equated despite their differences. The CUT method will not apply when substantial differences in intangibles occur.

\(^{41}\) Treas. Reg. § 1.482-4(c)(2)(iii).
\(^{42}\) Preamble for Treas. Reg. § 1.482-4.
\(^{43}\) Id.
\(^{44}\) Id.
\(^{45}\) Treas. Reg. § 1.482-4(c)(2)(ii).
\(^{46}\) Treas. Reg. § 1.482-4(c)(2)(iii).
EXAMPLE 3

The facts are the same as in the prior example except that Company Z incurs substantially more risks than Company Y and is performing substantially different functions and has different license terms. The CUT method does not apply.

The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of an intangible was arm’s length. The presence or absence of an arm’s-length transaction is determined by reference to an amount charged in a comparable uncontrolled transaction. The amount determined under the comparable uncontrolled transaction method may be adjusted by the IRS periodically unless exceptions apply. The “best method” factors apply in determining whether the results derived from application of the comparable uncontrolled transaction method are the “most reliable measure” of an arm’s-length result.

Reliability Standards

The comparable uncontrolled transaction generally provides the “most reliable measure” of an arm’s-length result that is consistent with the best method rule if the transactions are considered substantially the same. The comparable uncontrolled transactions provide the “most direct and reliable measure” of the arm’s-length result for the controlled transfer of an intangible when the transaction involves the “same intangible” and the circumstances are the same or “similar.” The reliability standard seeks an uncontrolled transaction that involves the transfer of the “same intangible” under the “same” or “substantially the same circumstances” as the controlled transaction. The reliability provisions in the intangibility regulations then delineate transactions that are “substantially the same.” Circumstances of the controlled and uncontrolled transactions will be considered substantially the same if, for these transactions:

- There are, at most, only “minor differences.”
- These differences have a “definite and reasonably ascertainable effect” on the amount charged.
- “Appropriate adjustments” for these differences are made.

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47 Treas. Reg. § 1.482-4(c)(1).
48 Id.; Treas. Reg. § 1.482-4(f)(2).
49 Treas. Reg. § 1.482-4(c)(2)(i).
50 Treas. Reg. § 1.482-4(c)(2)(ii).
51 Id.
52 Id.
53 Id.
54 Id.
55 Id.
The transfer price can be determined on the basis of “comparable intangibles under comparable circumstances”56 if there are no uncontrolled transactions under substantially the same circumstances; however, the presence of a comparable intangible rather than the same intangible, or the presence of comparable circumstances rather than the same or substantially the same circumstances, will reduce the reliability of the analysis.57 Nevertheless, the comparable uncontrolled transaction method may provide the most reliable measure of an arm’s-length result in these circumstances.

The regulations define “comparable intangible property” and “comparable circumstances,” which are discussed later in this chapter.58 The reliability rules do not seek to delineate differences that are “minor” from differences that are more than minor.59 Nor do these rules attempt to establish the criteria under which the differences are “reasonably ascertainable” within the context of intangibles. Also, the reliability rules do not attempt to determine the appropriateness of the adjustments made for these differences.60 These issues remain to be resolved in future by courts or by the regulatory process.

The reliability standard for intangibles under the comparable uncontrolled transaction method is essentially identical to the delineation of reliability for tangible transactions under the comparable uncontrolled price method. This comparison rule provides for transactions that are delineated as follows:61

- No differences
- Minor differences
- More than minor differences
- Material product differences

### Reliability in the Database

The regulations address the need for reliability within the context of the database. The reliability of the results derived from the comparable uncontrolled transaction method is affected by two components:62

1. The completeness and accuracy of the data used
2. The reliability of the assumptions made to apply the comparable uncontrolled transaction method

It is expected that there will be frequent disputes between taxpayers and the IRS about the database, regarding both the completeness of the data and its accuracy.

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56 Id.
57 Id.
60 Id.
Most often, the taxpayers and the IRS will argue over the relevance of a particular item or groups of data, such as the inclusion of a certain company’s data in the database. The reliability of the assumptions will be troublesome to the IRS because the taxpayer has a wide berth to make the assumptions, but reliability is troublesome to the taxpayer because the IRS, during the audit, has the advantage of hindsight.

**COMPARISON OF THE TRANSACTIONS**

The regulations provide for both direct and indirect comparisons of transactions involving intangibles. Direct comparisons are treated more favorably than are indirect comparisons.

**Direct Comparisons**

The comparable uncontrolled transaction method relies heavily on the comparability of the transactions. The general transfer pricing comparability provisions use five factors:

1. Functions
2. Contract terms
3. Risks
4. Economic conditions
5. Property or services

The comparability provisions also take into account the standards of comparability and special circumstances. These provisions apply to intangible property, but specific factors may be relevant to a particular intangible property. The regulations emphasize that application of the comparable uncontrolled transaction method requires that the analysis of controlled and uncontrolled transactions involve either the “same intangible property” or “comparable intangible property.” “Comparable intangible property” and “comparable circumstances” are defined by the regulations and are discussed later in this chapter.

Although the five factors apply for transfer pricing of intangibles, heavy emphasis is placed on contract terms and economic conditions. The methods are particularly dependent on the similarity in the terms of the contractual arrangements and on economic conditions. Differences in contract terms, or in the economic conditions in

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64 Id.
65 Treas. Reg. § 1.482-1(d)(3).
67 Id.
which the transactions take place, could materially affect the amount charged. Because of the impact of these differences on the amount charged, the comparable uncontrolled transaction method also depends on the similarity of these factors or on the adjustments to account for material differences in such factors. This method cannot be applied under the regulations, unless the intangible properties involved in the controlled and uncontrolled transactions are comparable.

In contrast to prior regulations, the 1994 final transfer pricing regulations provide additional guidance in determining whether the profit potential of two intangibles is in fact similar. It is necessary to have an “acceptably reliable measure” of the profit potential of the two intangibles in order to conclude that the profit potential of the two intangibles is similar. Profit potential is most reliably measured by “direct calculations.” These direct calculations are based on “reliable projections” of the net present value of the benefits to be realized through the intangible.

**Indirect Comparisons**

Information concerning the profit potential will frequently be available for the controlled transaction. However, information concerning the profit potential will not be available for an uncontrolled transaction unless one of the controlled taxpayers is a party to that transaction. The drafters of the regulations assert that they are aware of this difficulty. The regulations therefore provide that “in certain cases” it may be acceptable to refer to evidence other than projections to compare profit potential. This evidence is termed the “indirect comparison of the profit potential.”

Indirect comparisons would be most useful in cases in which it is not possible to directly calculate the profit potential of the intangibles. This absence of information concerning the profit potential could occur in the case of either a controlled transaction or an uncontrolled transaction. The indirect comparison technique is viable when the transfer of an intangible relates to only one component of an asset that consists of many components—an airplane or an automobile, for example. When there is a transfer of many components, it will be difficult to reliably calculate the net present value of the profit that is attributable to the intangible transferred in the controlled transaction. Because of the transfer of multiple components, it will be difficult to isolate the profit attributable to that intangible from the overall profit attributable to the final asset.

**Applying Indirect Comparisons**

Errors can be made in measuring the profit potential of the intangibles, but the profit potential of the intangibles and the potential for errors in measuring the profit potential are intertwined. The effects of the errors in measurement may increase as the overall profitability of the intangibles increases. As the positive potential increases,
the importance of reliably measuring the profit potential increases. In this regard, importance and reliability counteract each other. The reliability of indirect comparisons of profit potential decreases as profit potential in the controlled transaction increases.\(^75\)

The profit potential of the intangible property involved in the uncontrolled transaction might be “similar” to the profit potential of the intangible property involved in the controlled transaction, given the indirect measure of profit potential, when the overall profitability of the intangibles is “relatively small”\(^76\); however, the profit potential might not be similar under the circumstances if the overall profitability of the intangibles is much greater.

The regulations provide no further guidance to delineate the profit potential of intangible transactions that are “relatively small” from those that are “much greater.” Instead, the regulations indicate that the ultimate determination will depend on the facts and circumstances of each case.

### COMPARABLE INTANGIBLE PROPERTY

An uncontrolled transaction involving intangible property is considered comparable to a controlled transaction involving intangible property if:\(^77\)

- The intangible is used in connection with “similar products or processes” within the “same general industry or market.”\(^78\)
- The intangible has “similar profit potential.”\(^79\)

The regulations do not delineate the similarity of products or processes that would be considered comparable. This issue remains to be resolved in the future by the courts or by the regulatory process.

**Similar Profit Potential**

The “similar profit potential” standard is addressed more specifically in a part of the transfer pricing regulation.\(^80\) The approach is prospective and focuses on the computation of net present value of the benefits to be realized. The regulations specify two approaches to determine the prospective benefits:

1. The benefits are based on prospective profits to be realized.
2. The benefits are based on costs to be saved.

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\(^{76}\) Id.

\(^{77}\) Treas. Reg. § 1.482-4(c)(2)(iii)(B)(1).


\(^{80}\) Id.
The profit potential of an intangible is most reliably measured by the net present value of the benefits to be realized through the use or subsequent transfer of the intangible. The profit potential should include the following:\textsuperscript{81}

- Capital investment
- Start-up expenses
- Risks to be assumed
- Other relevant considerations

The transfer pricing regulations do not directly address the determination of the interest rate to be used in computing present value, nor do they explore potential debt-equity considerations in determining capital investment or the definition of “start-up expenses.” Such issues remain to be resolved by the courts or by the regulatory process.

**Reliability of the Measurements**

The regulations address the importance of reliability in measuring profit potential. The need to “reliably measure” the profit potential increases in relation to both of the following factors:\textsuperscript{82}

1. The total amount of potential profits
2. The potential rate of return on investment necessary to exploit the intangible

The regulations recognize that the information needed to directly compute present value might not be available, and that the reliability of the profit measure is reduced when potential profits are “relatively small.”\textsuperscript{83} No attempt was made in the regulations to determine the nature of that condition, or whether smallness is to be computed in comparison with other activities in the industry or business or with the results in prior years; however, the regulations refer to the reduction in the reliability of the profit measure in situations in which the potential profits are relatively small in terms of total amount and rate of return. When this reliability measure is reduced, the comparison of the profit potential may be based on the “comparable circumstances” factors discussed in the following section.\textsuperscript{84} Example 3 in the intangibility regulations provides an illustration in which profitability data is reduced.

Reliability of the profit measure depends upon the ability to isolate the profit.\textsuperscript{85} The reliability of a measure of potential profit affects the isolation of the profit that gives rise to the intangible. The regulations recognize that isolation could apply to profit that is attributable to other factors. In this regard, the regulations, by example, speak of functions performed and other resources employed.

\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Id.
\textsuperscript{84} Treas. Reg. § 1.482-4(c)(2)(iii)(B)(2).
COMPARABLE CIRCUMSTANCES

Circumstances of the controlled transaction are compared with circumstances of the uncontrolled transaction as part of the analysis of intangible transactions. This method is referred to as the “comparable circumstances” method, and it is within the comparable uncontrolled transaction method. All of the comparability factors must be considered: functions, contract terms, risks, economic conditions, and property or services; however, eight specific factors may be particularly relevant to this method:

1. The terms of the transfer, including:
   - The exploitation rights granted in the intangible
   - The exclusive or nonexclusive character of the rights granted
   - Any restrictions on use
   - Any limitations on the geographic area in which the rights may be exploited

2. The stage of development of the intangible in the market in which the intangible is to be used. The stage of development includes, where appropriate, necessary governmental approvals, authorizations, or licenses. Such regimes as environmental protection, health, and safety appear to be included in this comparison, but inclusion of the facets of the production process itself, such as labor and human services, is less certain.

3. The rights to receive updates, revisions, or modifications of the intangible. The regulations do not specifically refer to grant-backs in this context, but the presence or absence of grant-backs and the nature of the grant-back should be relevant to this inquiry.

4. The uniqueness of the property and the period for which the property remains unique. Uniqueness includes the degree and duration of the protection afforded to the property under the laws of the relevant countries. The regulations do not define “unique” other than in the context of protection. The scope of the subrule as to uniqueness is uncertain, but it appears that the regulations are referring specifically to patent technology. Examples in the intangibility section of the regulations obliquely discuss the concept of uniqueness that transcends the protection facets of the intangible.

5. Time periods, including the duration of the license, contract, or other agreement. Also, termination of the agreement and renegotiation rights are to be taken into account.
6. The “economic and product liability” risks to be assumed by the transferee. Although product liability risks are ascertainable and could be insured against, that situation is different for economic risks.

7. The relationship between the transferee and the transferor. This relationship includes the existence and extent of any collateral transactions or ongoing business relationships. Within the context of the comparable circumstances rule, “collateral transactions” is much broader than the application of financial collateral for a transaction.

8. The functions to be performed by the transferor and the transferee, including “ancillary or subsidiary services.” The phrase “ancillary or subsidiary services” is not defined in the intangibility rules, but is defined in the regulations pertaining to Domestic International Sales Corporations.

EXAMPLES

The intangibility section of the regulations contains four examples, all of which focus on the comparable uncontrolled transaction method. In addition, one of the best method examples explores the transfer pricing methodologies for intangibles.

Best Method Examples

USpharm is a pharmaceutical company in the United States, and Xpharm is its subsidiary in country X. USpharm develops a new drug, Z, that is a safe and effective treatment for the disease “zeezee.” USpharm has obtained patents for Z in the United States and in various foreign countries and has obtained the regulatory authorization necessary to market Z in the United States and in foreign countries.

USpharm licenses Xpharm to produce and sell Z in country X. At the same time, USpharm licenses Ydrug, an unrelated company, to produce and sell Z in country Y, a neighboring country of country X. USpharm obtained patent protection and regulatory approvals in countries X and Y before the licenses were issued. Both countries provide similar protection for intellectual property rights. Country X and country Y are similar in terms of population, per capita income, and incidence of zeezee. As a result, Z is expected to sell in similar quantities and in similar prices in both countries. In addition, the cost of producing X in each country is expected to be approximately the same. The example in the regulations does not discuss the costs of marketing Z nor the comparison of the costs of marketing Z in country X and in country Y.

97 Treas. Reg. § 1.993-1(d).
99 Treas. Reg. § 1.482-8, Example 7.
The terms of the license between USpharm and Xpharm are identical in every respect, including royalty rate, to the license between USpharm and Ydrug. In this case, the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm’s-length royalty rate for the Xpharm license agreement. In this case, for the following two reasons, the comparable uncontrolled transaction method is more likely to provide a more reliable measure of an arm’s-length result than any other method:

1. The same property is transferred in the controlled transaction and in the uncontrolled transaction.
2. The circumstances under which the transactions occurred are substantially the same.

**EXAMPLE 1**

The facts are the same as in the best method example discussed previously, except that the costs of marketing Z in country X and in country Y are expected to be approximately the same. Here the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm’s-length royalty rate for the Xpharm license agreement. The additional comparison of the marketing costs in country X and in country Y should enhance the likelihood that the comparable uncontrolled transaction method would be the best method; however, this issue was not discussed in the example for the regulations.

**EXAMPLE 2**

The facts are the same as in Example 1 except that the incidence of zeezee is much higher in country Y than country X. Accordingly, the profit potential from exploitation of the right to make and sell Z is likely to be much higher in country Y than in country X. The example states that, because of that difference, the Ydrug license agreement is unlikely to provide a reliable measure of the arm’s-length royalty rate for the Xpharm license. By reaching this result, the regulations narrow the range of comparability that would be acceptable. Instead, Y’s royalty rate should be a starting point to determine X’s royalty rate. Adjustments could then be made for revenue and costs, including revenue projections, the depreciation of equipment, and marketing costs. This example is likely to be cited by parties, whether the taxpayer or the Service, seeking to deny comparability of an intangible.

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100 Treas. Reg. § 1.482-4(c)(4), Example 1.
The example uses uncontrolled comparables that are “clearly similar” to the controlled transaction, but assumes that there are “material differences” between the uncontrolled comparables and the controlled transaction. The interquartile range is used to determine the results under the comparable uncontrolled transaction method. Nuances in the transactions affect the comparison used.

FP is a foreign company that has a U.S. subsidiary, USSub. FP designs, manufactures, and sells industrial equipment and has developed “proprietary components” that are incorporated into its products. These components are “important” in the operation of “FP’s equipment,” and some of these components have “distinctive features.” “FP’s equipment” in this context appears to relate to the FP products used by the customers of FP, not to FP’s production process.

Other companies produce “similar” components. The components are relatively minor in importance on an overall basis, although the components are important to the operation of FP’s equipment. The example indicates that “none of these components by itself” accounts for “a substantial part” of the value of FP’s products.

FP licenses to USSub the exclusive North American rights to use the patented technology for producing component X. This component is a heat exchanger that is used for cooling operating mechanisms in industrial equipment. Component X incorporates “proven technology” that makes it “somewhat more efficient” than heat exchangers commonly used in industrial equipment. The example does not explicitly state that USSub will produce component X, but this result can be ascertained from the ensuing portion of the example.

FP agrees to provide technical support to help adapt component X to USSub’s products and to assist with initial production. Under the terms of the license agreement, USSub pays FP a royalty equal to 3 percent of the USSub equipment incorporating component X.

FP does not license the use of component X to unrelated parties. (Analysis of the intangible would be greatly simplified if FP did license component X to unrelated parties.) However, many “similar” components are transferred between uncontrolled taxpayers. The district director decides to apply the comparable uncontrolled transaction method to evaluate whether the 3 percent royalty for component X is arm’s length. The district director uses data from the similar components in this analysis.

The IRS audits USSub, and in so doing, questions the royalty for component X. The district director uses a database of documents filed with the Securities and Exchange Commission (SEC) to identify potential license agreements with uncontrolled taxpayers that could be comparable to the license for component X. In practice, however, the SEC database concerning intangibles and the royalties may be inadequate. The records will lack the specific parameters that affect the licenses. In addition, companies are unlikely to provide data concerning royalties for transactions that are less than “a substantial part” of the value of the products.

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102 Treas. Reg. § 1.482-4(c)(4), Example 3.
In this example, the IRS did not rely on its own tax database. Nothing in the regulations precludes the use of IRS data, even though the taxpayer would not have access to the database. This issue seems ripe for litigation.

In this example, the district director culls the royalty data to select the data that is most appropriate. The district director identifies 40 license agreements that were entered into in the same year as the controlled transfer or in the prior or following year. These license agreements relate to the transfer of technology associated with industrial equipment that has “similar applications” to USSub’s products. As a matter of practice, however, data concerning these applications are not likely to be disclosed to the SEC, partly because these transactions are not substantial relative to the income or value of the company.

The district director reviews the 40 agreements based on technical sophistication. Of these, 25 agreements involve components with a level of technical sophistication similar to that of component X. Furthermore, these 25 agreements could be expected to play a similar role in contributing to the total value of the final product. Again, the use of the SEC data for that analysis is open to question.

The district director then makes a detailed review of the terms of those 25 agreements and finds that 15 agreements are similar to the controlled agreement, in that they all involve the following seven items:

1. The transfer of exclusive rights for the North American market
2. Markets of similar size
3. The transfer of patent technology
4. Continuing technical support
5. Access to technical improvements
6. Technology of a similar age
7. A similar duration for the agreement

The district director concludes that these 15 intangibles have similar profit potential to the component X technology. The district director reached this result for two reasons:

1. The seven factors previously listed
2. None of the components to which these license agreements relate accounts for a substantial part of the value of the final products.

The 15 uncontrolled comparables produce the following royalty rates:

<table>
<thead>
<tr>
<th>License</th>
<th>Royalty Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.0</td>
</tr>
<tr>
<td>2</td>
<td>1.0</td>
</tr>
<tr>
<td>3</td>
<td>1.25</td>
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<tr>
<td>4</td>
<td>1.25</td>
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<tr>
<td>5</td>
<td>1.5</td>
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<tr>
<td>6</td>
<td>1.5</td>
</tr>
<tr>
<td>7</td>
<td>1.75</td>
</tr>
</tbody>
</table>
The uncontrolled comparables are “clearly similar” to the controlled transaction. Nevertheless, the example states that “it is likely that unidentified material differences exist between the uncontrolled transaction and the controlled transaction.” In practice, the comparative data described in this section are more closely comparable than could be obtained in ordinary circumstances. An “appropriate” statistical technique must be used, because of these differences, to establish the arm’s-length range. In this case, the district director uses the interquartile range. The arm’s-length range covers royalty rates from 1.25 percent to 2.5 percent under the interquartile range limitation.

An adjustment is warranted from the 3 percent royalty charged in the controlled transfer. The district director then determines that the “appropriate” adjustment corresponds to a reduction in the royalty rate to 2.0 percent, which is the median of the uncontrolled comparables.

USdrug is a U.S. pharmaceutical company that has a newly established European subsidiary, Eurodrug. USdrug has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no side effects. Nosplit replaces another drug, Lessplit, for migraine headaches. USdrug had previously produced and marketed Lessplit.

Several other drugs for treating migraine headaches are already on the market, but Nosplit can be expected to rapidly dominate the worldwide market for such treatments. Nosplit is expected to command a premium price because all other treatments for migraines produce side effects. As a result, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

USdrug licenses to Eurodrug the rights to produce and market Nosplit in the European market. USdrug had previously licensed to an unrelated European pharmaceutical company the right to produce and market Lessplit in the European market. USdrug considers the royalty rate that it had used for Lessplit in setting the royalty rate for Nosplit.

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**EXAMPLE 4**

USdrug is a U.S. pharmaceutical company that has a newly established European subsidiary, Eurodrug. USdrug has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no side effects. Nosplit replaces another drug, Lessplit, for migraine headaches. USdrug had previously produced and marketed Lessplit.

Several other drugs for treating migraine headaches are already on the market, but Nosplit can be expected to rapidly dominate the worldwide market for such treatments. Nosplit is expected to command a premium price because all other treatments for migraines produce side effects. As a result, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

USdrug licenses to Eurodrug the rights to produce and market Nosplit in the European market. USdrug had previously licensed to an unrelated European pharmaceutical company the right to produce and market Lessplit in the European market. USdrug considers the royalty rate that it had used for Lessplit in setting the royalty rate for Nosplit.

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The Lessplit and Nosplit license agreements are closely comparable in many respects:

- The drugs were licensed at the same stage in their development.
- The agreements conveyed identical rights to the licensees.
- There appear to have been no significant changes in the European market for migraine headache treatments since Lessplit was licensed.

Several similar headache treatment drugs were already on the market when Lessplit was licensed. Lessplit was not superior in all cases. For these reasons, actual and projected profits for Lessplit were substantially lower than the projected Nosplit profits. As a result, USdrug concludes (and the IRS would presumably agree) that the profit potential for Lessplit is not similar to the profit potential for Nosplit. The Lessplit license agreement is not a comparable uncontrolled transaction, despite the other indicia of comparability between the two intangibles.

**APPLYING UNSPECIFIED METHODS FOR INTANGIBLE PROPERTY**

In general, the transfer pricing regulations for intangible property provide for three specified methods—the comparable uncontrolled transaction method, the comparable profits method, and the profit split method—but the taxpayer is not limited to the use of these three transfer pricing methods. A fourth method, an “unspecified transfer pricing method,” may be acceptable to the IRS if specific requirements, discussed later in this section, are met. The unspecified method for intangibles is analogous to the rule for unspecified methods for tangible property.

An unspecified method for intangibles may be used to evaluate whether the amount charged in a controlled transaction is arm’s length. The general principles and guidelines, which also apply to the transfer of tangible property, also apply to the transfer of intangible property. As such, the arm’s-length standard and the best method rule apply. Thus an unspecified method is acceptable only if this method is the best method.

An unspecified method may rely on internal data, rather than on uncontrolled comparables. If such an unspecified method is used, the reliability of the data will be reduced and the unspecified method might not be the best method. Reliability will be affected by the reliability of the data and the assumptions used to apply the unspecified method. Data and assumptions used in projections may also affect reliability.

**Evaluation Process and “Realistic Alternatives”**

Both unspecified methods and the specified methods must take into account the general principle that (at least in theory) uncontrolled taxpayers “evaluate” the terms of a transaction by considering the “realistic alternatives” to that transaction. Further...

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104 Treas. Reg. § 1.482-4(d)(1).
105 Id.
thermore, uncontrolled taxpayers would, according to this rule, enter into a particular transaction only “if none of the alternatives is preferable to it.”\textsuperscript{106} We refer to this selection process as the “no-alternative” rule or the “last resort” rule. The no-alternative methodology has several practical difficulties, including the following:

- An evaluation of all the transactions might never take place in many instances. Although a taxpayer may undertake this evaluation process for its larger transactions, whether “larger” is measured in absolute terms or on a percentage basis, other transactions will be shunted aside.
- It will be difficult to assess which courses of action are alternatives to the present course of action and whether these alternatives are, in fact, realistic.
- The no-preference rule, when “none of the alternatives is preferable,” would require the taxpayer to weigh alternatives; in fact, many of the alternatives would be merely speculative.
- The no-preference test suggests that one course of action will always be clearly preferable to other actions. In fact, many situations could be equally acceptable. The selection of alternatives could be random in some situations.

The following example illustrates the no-alternative rule. The comparable uncontrolled transaction method compares a controlled transaction to similar uncontrolled transactions. This comparison provides a “direct estimate” of the price that the parties would have agreed to if they had resorted directly to a market alternative to the controlled transaction. The example provides that an unspecified method should provide information on the prices that the controlled taxpayer would have realized. As a result, an arm’s-length result is achieved by choosing a reasonable alternative to the controlled transaction.\textsuperscript{107}

\textbf{“Most Reliable Measure”}

An unspecified method, like any method, will not be applied unless the method provides “the most reliable measure” of an arm’s-length result under the principles of the best method rule.\textsuperscript{108} The regulations do not indicate the criteria that could be used to determine the most reliable measure of the arm’s-length result. In addition, the reliability of the measure may be difficult to assess in practice.

The rules for the comparability of transactions apply to unspecified intangible pricing methods, in addition to applying to other transactions. A taxpayer can rely solely on in-house comparables, but external data is treated more favorably. Reliability will be reduced if a method relies on “internal data” rather than uncontrolled comparables. Because internal data use could diminish the reliability of the transfer pricing results, this internal data method might not prove to be the best method in a specific situation. Although the term “internal data” is not defined by the transfer pricing regulations for intangible property, it appears that the term “internal data”

\textsuperscript{106} \textit{Id.}
\textsuperscript{107} \textit{Id.}
\textsuperscript{108} \textit{Id.}
refers to transactions between two controlled entities. External data and “uncon-
trolled comparables” should refer to transactions between a controlled entity and an
uncontrolled entity. Note that, for tangible property, both the resale method and the
cost-plus method favor transactions between a controlled entity and an uncontrolled
entity.

The regulations implicitly recognize the importance of projections in determin-
ing the reliability of data and assumptions. The reliability of unspecified methods will
be affected by the reliability of the data and assumptions used to apply the unspeci-
"cied methods, “including the projections used.”

**EXAMPLE**

**Unspecified Methods**

The regulations provide an example in which an unspecified method was analyzed
and ultimately rejected under the best method rule. USbond is a U.S. company, and
Eurobond is its foreign subsidiary. USbond licenses to Eurobond a proprietary
process that permits the manufacture of Longbond, a long-lasting industrial adhe-
sive. USbond also manufacturers and markets Longbond in the United States.

The Longbond process provides for manufacturing of the adhesive at a substan-
tially lower cost than would otherwise be possible. Eurobond manufactures Long-
bond and sells the product to both related and unrelated parties at the market price,
which is $550 per ton.

The best method rule applies in determining of the license of Longbond from
USbond to Eurobond. Here, the use of a hypothetical or substitute price may be the
best method. The district director may consider the alternative of Eurobond’s pro-
ducing and selling Longbond in the United States. This substitute method should
evaluate whether the consideration paid for the transfer of the proprietary process to
Eurobond is arm’s length.

The substitute amounts that would determine the hypothetical amounts should
be based on “reasonably reliable estimates.” Here, such estimates indicate that,
under the substitution hypotheses, USbond would directly supply Longbond to the
European markets. Under the direct sales approach, a selling price of $300 per ton
would cover USbond’s production and selling costs. This amount would provide
USbond with a “reasonable profit” for its functions, risks, and investment. This
investment would be based on capital associated with the production of Longbond
for the European market.

In this example, it has already been determined that the market price for Long-
bond was $550 per ton. USbond would forego $250 per ton profit, the difference
between the market price and the $300 selling price. This profit is to compensate
USbond for its functions, risks, and investment in supplying Longbond to the Euro-

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pean market. Based on these facts, the district director concludes that a royalty of $100 for the proprietary process is not arm’s length.

COORDINATION BETWEEN TANGIBLE PROPERTY AND INTANGIBLE PROPERTY

The transfer pricing regulations delineate transfers that are subject to the tangible property rules and transfers that are subject to the intangible property rules. The regulations generally treat transfers of embedded intangibles as subject to the intangible property rules. An “embedded intangible” is tangible property that is affected by the presence of an intangible, such as a trademark that is affixed to the tangible property. The value of the tangible property may be affected by the value of the intangible.

The general rule for the delineation between tangible and intangible property is that the transfer of tangible property having an embedded intangible will be considered as a transfer of the tangible property and will not be considered as a transfer of the intangible. The difference in value between tangible property with the embedded intangible and tangible property without the embedded intangible is disregarded if the controlled purchaser does not acquire any rights to exploit the intangible property. An acquisition of rights by the controlled purchaser excludes from the no-acquisition rule the rights relating to resale of the tangible property under normal commercial practices.

The general transfer pricing rules address five aspects of comparability, one of which is the comparison of property or services. The embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. Product comparability has the greatest effect on application of the comparable uncontrolled price method. For this reason, trademarked property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method.

The effect of embedded intangibles on comparability will be determined under the transfer pricing rules for intangibles. The transfer of tangible property may convey to the recipient a right to exploit an embedded intangible. If the transfer includes these rights, it may be necessary to determine the arm’s-length consideration for such intangible separately from the tangible property. In this regard, it will be necessary to apply methods that are appropriate to determining the arm’s-length result for a transfer of intangible property under the intangible transfer pricing regulations. This transfer pricing rule applies rather than the general rule for embedded intangibles; however, the preceding rules do not apply to transfers of embedded intangibles that are made in connection with the resale of that item of tangible property.

110 Treas. Reg. § 1.482-4(e).
The transfer pricing examples provide an illustration that limits the embedded intangible rule. The transfer of a machine conveys the right to exploit the manufacturing processes that are incorporated into the machine. In that event, the arm’s-length consideration for the transfer of that right must be determined separately under the transfer pricing rules for intangibles.

**SPECIAL RULES FOR TRANSFERS OF INTANGIBLE PROPERTY**

Special rules apply to transfers of intangible property. These transfer pricing regulations affect five facets of intangible property:

1. The form of the consideration
2. Periodic adjustments
3. The ownership of intangible property
4. The amount of the consideration
5. Lump sum payments

The Treasury Department issued regulations that provide for various exceptions to the periodic adjustment rule. Most important, the regulations continue the periodic adjustment rule and modify the ownership rules for intangibles.

**FORM OF THE CONSIDERATION**

The special rules for transfers of intangible property characterize the nature of the consideration. The arm’s-length consideration is presumed to be a royalty unless a different form is “demonstrably more appropriate.” The transfer is generally categorized as a royalty when:

- A controlled taxpayer pays nominal or no consideration for the right to an intangible.
- The transferor retains a substantial interest in the intangible.

**PERIODIC ADJUSTMENTS**

Multiyear intangible transfers, including royalty agreements, are subject to special scrutiny by the IRS. As a general rule, the IRS may adjust the consideration

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111 Treas. Reg. § 1.482-3(f).
112 Treas. Reg. § 1.482-4(f).
charged in a taxable year if the intangible is transferred under an arrangement that covers more than one year. The consideration charged in a taxable year may be adjusted to ensure that the arrangement is “commensurate with the income that is attributable to the intangible.” The transfer pricing regulations for intangible property refer to these provisions as the “periodic adjustment” provisions.115

The transfer pricing regulations provide that periodic adjustments for intangibles should be “consistent with the arm’s-length standard” and with the “general principles and guidelines” pertaining to transfer pricing.116 The preamble to the regulations states that this provision is required by the 1986 amendment to Section 482.117 A taxpayer that opposes the transfer pricing adjustment may prevail if the taxpayer can demonstrate that the adjustment deviates from the general principles and guidelines or that the adjustment deviates from the arm’s-length standard.

The transfer pricing regulations enable the IRS to consider information from other taxable years if the arrangement encompasses more than one year. The district director may consider all relevant facts and circumstances “throughout the period the intangible is used.”118 Even though the information used by the IRS transcends the taxable year, each year stands on its own when it comes to the adjustment process. The IRS might not have made a transfer pricing adjustment in a prior year, but the taxpayer cannot rely upon this failure on the part of the IRS to have made a prior adjustment to prevent a subsequent adjustment being made. The determination, in a prior taxable year, that the amount charged for an intangible was an arm’s-length amount will not preclude the district director, in a subsequent taxable year, from making an adjustment to the amount charged for the intangible in the taxable year.

The transfer of the intangible may have taken place many years ago. As a result, the original transfer of the intangible may no longer be open for statute-of-limitation purposes. Nevertheless, a periodic adjustment under the commensurate-with-income requirement of Section 482 may be made in the subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute-of-limitation purposes.

The periodic adjustment rule could give the IRS unwarranted discretion and could be costly and repetitive to the taxpayer. The transfer pricing regulations pertaining to intangibles limit the application of the periodic adjustment rule. Exceptions to the periodic adjustment rule are discussed in the next section.

**EXCEPTIONS TO PERIODIC ADJUSTMENT PROVISIONS**

Five exceptions to the transfer pricing rules preclude periodic adjustments for payments made in conjunction with intangible property:119

116 Id.
1. Transactions involving the same intangible
2. Transactions involving a comparable intangible
3. Methods other than comparable uncontrolled transactions
4. Extraordinary events
5. The five-year period

The first two exceptions in the 1994 final transfer pricing regulations are carried over from the 1993 temporary regulations. The final 1994 regulations added the last three exceptions.

**Transactions Involving the Same Intangible**

Periodic payments concerning a controlled transfer of intangible property are ordinarily subject to transfer pricing allocation by the IRS; however, if the following four conditions apply, no allocation is made in a subsequent taxable year:120

1. The “same intangible” was transferred to an uncontrolled taxpayer.
2. The transfer took place under “substantially the same circumstances” as those of the controlled transaction.
3. This transaction is determined to be arm’s length under the comparable uncontrolled transaction method and as such serves as the basis for application of the comparable uncontrolled transaction method in the first taxable year in which the “substantial periodic consideration” was required to be paid.
4. The amount paid in the year was an arm’s-length amount under the comparable uncontrolled transaction method.

The “same intangible” rule is an alternative to the “comparable intangible” rule, the “non-CUT” rule, the “extraordinary events” rule, and the “five-year” rule. The “same intangible” rule has many vagaries, as each of the four requirements creates more uncertainty. Consider the questions raised by each of the four standards.

The “same intangible” exception to the periodic adjustment rule raises several issues that have to be addressed, including:

- What degree of sameness for the intangible will be required to comply with the first requirement?
- When are intangibles “the same” and when are they “similar”?
- Is identity to be based on prior use of the intangible or on prospective use?

The “substantially the same circumstances” requirement also raises several issues to be addressed, including:

- Are the circumstances that create the transfer to be based on the sameness of the geographic market?
- Does the timing of the transactions affect the similarity of the circumstances?

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Does the currency used in the agreement affect the circumstances of the transfer?  
What are the outer limits that determine “substantially”?  

The preamble to the transfer pricing regulations examines one issue raised in comparing geographic markets. In this example, the consideration for the transfer of an intangible to a controlled taxpayer in one country could be determined to be arm’s length, based on the transfer of the “same intangible” to an uncontrolled taxpayer in another country in which the “relevant economic conditions” were “substantially similar” to those in the first country. In such a case, no periodic adjustments would be made if the transactions occurred under “substantially similar circumstances.”  

The regulations indicate that the first exception to the periodic adjustment rule requires an initial payment that is more than nominal. The payment should be “substantial periodic consideration,” but this term is not defined. Issues, including the following, must be addressed:

- Is the substantial nature of the payment to be based on a percentage of the total payment?  
- Is there an amount that in and of itself constitutes a substantial periodic consideration?  

The fourth requirement for the “same intangible” rule that would preclude periodic adjustments speaks of “an” arm’s-length amount, thus emphasizing that there need not be just one arm’s-length amount; however, several issues remain, including the following:

- Is any arm’s-length amount to be included in the transfer, so long as the amount is arm’s length?  
- Is the arm’s-length range to be truncated to determine the arm’s-length amount?  
- Must the best method rule be applied in these circumstances?

Transactions Involving a Comparable Intangible

The second alternative in avoiding the periodic adjustment rule for intangible property (which pertains to periodic transfer pricing adjustments) is to comply with the specific rules for a “comparable intangible.” To qualify, the arm’s-length result must be derived from application of the comparable uncontrolled transaction method. This transfer pricing method must be based on the transfer of a “comparable intangible” under “comparable circumstances” (i.e., circumstances that are comparable to those of the controlled transaction). No allocation will be made if the requirements for the “comparable intangible” rule are met. The test is met if all of the following six facts are established:

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121 Preamble for Treas. Reg. § 1.482-4.  
1. The controlled agreement
2. The uncontrolled agreement
3. Similarity
4. Limits
5. Functional similarity
6. Aggregate profits and costs

The “comparable profits” rule is an alternative to the “same intangible” rule, the “non-CUT” rule, the “extraordinary events” rule, and the “five-year” rule. This provision was carried forward from the 1993 temporary regulations to the 1994 final regulations, except that the sixth item, aggregate profits and costs, was modified.

**Controlled Agreement**  The first portion of the “comparable intangible” exception to the periodic adjustment rule pertains to the “controlled agreement,” which is the agreement between the controlled taxpayer and a controlled party. The controlled agreement portion of the exception will qualify if the controlled agreement meets all four requirements:

1. The agreement must be in writing.
2. The agreement must provide for an amount of consideration for each taxable year subject to the agreement.
3. The agreement must be an arm’s-length amount for the first taxable year in which “substantial periodic consideration” was required to be paid under the agreement.
4. The agreement must remain in effect for the taxable year under review.

Compliance with the first portion of the comparable intangible exception to the periodic adjustment rule will be difficult, because the term “substantial periodic consideration” is hard to assess.

**Uncontrolled Agreement**  The second portion of the “comparable intangible” exception to the periodic adjustment rule pertains to the “uncontrolled agreement,” the agreement between the controlled taxpayer and an uncontrolled party. The uncontrolled agreement portion of the exception will qualify if the uncontrolled agreement meets all five requirements:

1. The agreement must be in writing.
2. The agreement must set forth the terms of the comparable uncontrolled transaction that is relied upon to establish the arm’s-length consideration.
3. The agreement must contain no provisions that would permit any change to the amount of the consideration, a renegotiation, or a termination of the agreement.

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4. The no-change rule applies in circumstances that are comparable to those of the controlled transaction in the taxable year under review.

5. Provisions that permit specified, noncontingent periodic changes to the amount of the consideration are permitted.

**Similarity** The third portion of the “comparable intangible” exception to the periodic adjustment rule pertains to the similarity of the agreements. The controlled agreement must be “substantially similar” to the uncontrolled agreement. This similarity must apply to the time period for which the agreement is effective and to the provisions described under the uncontrolled agreement rules. The regulations do not define the term “substantially similar.”

**Limits** The fourth portion of the “comparable intangible” exception to the periodic adjustment rule pertains to the limits on use of the intangibles. The controlled agreement must limit use of the intangibles to a “specified field or purpose.” The limitation must apply in a manner that is consistent with “industry practice” and any such limitation in the uncontrolled agreement. “Specified field” is not defined by the regulations, and neither is “field or purpose.” The use of “industry practice” in assessing the limits on use of the intangibles may necessitate the use of expert witnesses in testimony before the court.

**Functional Similarity** The fifth portion of the “comparable intangible” exception to the periodic adjustment rule pertains to the functions performed. The taxpayer must be able to demonstrate that there are “no substantial changes” in the functions performed by the controlled transferee after the controlled agreement was executed. Events that were not foreseeable are excluded from this analysis.

**Aggregate Profits or Aggregate Cost Saving** The sixth portion of the “comparable intangible” exception to the periodic adjustment rule pertains to the comparison between actual and foreseeable aggregate profits or aggregate cost saving from exploitation of the intangible. The amount of the aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer is compared with foreseeable amounts. The actual amounts are determined for the year under examination and all past years.

The aggregate profits or aggregate cost saving provision was carried forward from the 1993 temporary regulations to the 1994 final regulations in modified form. In the 1993 regulations, the profits subject to the comparison were only the projected and annual profits for all open years. Under the final regulations, this comparison applies to all past years, not just open years, which in many cases will be a longer

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130 Preamble for Treas. Reg. § 1.482-4.
period. This modification enlarges the pool of data taken into account for purposes of this comparison. It generally will be less likely that the taxpayer’s actual profits will be outside the band of projected profits that is caused solely by timing variances. As a result, the drafters of the regulation suggest that fewer periodic adjustments will arise under these provisions.

The actual amounts for the comparison must be not less than 80 percent or more than 120 percent of the “foreseeable amounts.” Foreseeable amounts are prospective profits or cost savings that were foreseeable, determined as of the time that comparability of the uncontrolled agreement was established. Comparability of the agreement, in turn, is based on many factors, including functions, contractual terms, risks, and economic conditions.

Methods Other Than the CUT Method

A transfer pricing method that is outside of the scope of the comparable uncontrolled transaction method may nevertheless qualify for an exception to the periodic adjustment rule, which is termed here the “non-CUT exception.” As such, the payments made under the non-CUT exception may not be disturbed by the IRS. This exception to the periodic adjustment rule applies to an amount that constitutes an arm’s-length amount. The non-CUT exception applies if each of the following four facts are established:

1. Written agreement
2. Contemporaneous documentation
3. Consistent functions
4. Total profits and cost savings

The non-CUT method is an alternative to the “same intangible” method, the “comparable intangible” method, the “extraordinary events” test, and the “five-year” rule that limit periodic adjustments.

Written Agreement

The first portion of the non-CUT method exception to the periodic adjustment rule pertains to the controlled agreement. The agreement must meet the following three standards:

1. The controlled agreement must be between the controlled taxpayers and must be in writing.
2. The agreement must provide for an amount of consideration for each taxable year.
3. The agreement must remain in effect for the taxable year under review.

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**Contemporaneous Documentation**  The second portion of the non-CUT method exception to the periodic adjustment rule pertains to the arm’s-length amount and to documentation.\(^{136}\) Two requirements apply within this second portion of the non-CUT rule:

1. The consideration called for in the controlled agreement must be an arm’s-length amount for the first taxable year in which “substantial periodic consideration” (which is not defined in the regulation) is required to be paid.
2. The relevant “supporting documentation” must be “prepared contemporaneously” with execution of the controlled agreement.

The term “supporting documentation prepared contemporaneously” should be identical to “contemporaneous documentation,” which term is encompassed within the accuracy-related transfer pricing penalty.\(^{137}\) The term “supporting documents” should be identical for the non-CUT method and for the penalty exclusion.

**Consistent Functions**  The third portion of the non-CUT method exception to the periodic adjustment rule pertains to the consistency of the functions performed. The taxpayer must specify that there have been “no substantial changes” in the functions performed by the transferee since the controlled agreement was executed.\(^{138}\) Changes in functions are excluded for this analysis if the changes in function are required by events that were not foreseeable.

**Total Profits and Cost Savings**  The fourth portion of the non-CUT method exception to the periodic adjustment rule pertains to the consistency between actual amounts and projected amounts that are used for income statement purposes. Actual income amounts are determined from the year under examination and all past years. The actual amounts that are taken into account are as follows:\(^{139}\)

- The total profits actually earned by the controlled transferee from exploitation of the intangible
- The total cost savings realized by the controlled transferee from exploitation of the intangible

The non-CUT exception to the periodic adjustment rule can apply if the actual amounts (as determined by the preceding) are neither less than 80 percent nor more than 120 percent of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into. This provision was modified and “liberalized” in the final regulations as compared to the 1993 temporary regula-

\(^{137}\) See *Transfer Pricing Handbook*, Chapter 54.
The relevant time period for making this comparison is forever rather than for open years.

**Extraordinary Events**

The rules for periodic adjustments do not apply to intangibles if the taxpayer meets the “extraordinary events test.” This exception to the periodic adjustment rule is an alternative to the “same intangible” rule, the “comparable intangible” rule, the “non-CUT” rule, and the “five-year” rule. No adjustments will be made if the aggregate actual profits fall outside the permissible band of projected profits. All facets of the “same intangible” rule or the “comparable intangible” rule (both of which are described later in this chapter) must apply for the “extraordinary events” rule to apply. In addition, the taxpayer appears to have the burden of demonstrating the impact of the extraordinary events, both as to control of the events and as to anticipation of the events, in complying with the extraordinary events test.

The taxpayer seeking the exception must meet three requirements under the extraordinary events test:

1. The events must be “beyond the control” of the controlled taxpayers, whether natural or manmade, but not routine events, such as the failure of a market to develop as anticipated.
2. The events could not “reasonably have been anticipated” at the time the controlled agreement was entered into.
3. The aggregate actual profits of the aggregate cost saving realized by the taxpayer must be less than 80 percent of the prospective profits or cost savings or more than 120 percent of the prospective profits or cost savings.

The transfer pricing regulations do not delineate the physical characteristics of an event that would be considered extraordinary. The determination of an event as extraordinary is based on knowledge, behavior, and numerical analysis. Extraordinary events are normally considered in other contexts to include fire, flood, famine, riot, war, civil disobedience, acts of God, or similar events, but the transfer pricing regulations are silent regarding this delineation.

It will be difficult to apply the extraordinary event regulation in practice because the taxpayer will have the obligation to prove the following:

- The taxpayer anticipated foreseeable events.
- Realized events were beyond what was contemplated.
- The taxpayer’s anticipation of the events was reasonable.

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140 Preamble for Treas. Reg. § 1.482-4.
In addition, the taxpayer will need to demonstrate a negative—that the taxpayer lacked control over the event—for the event to be considered extraordinary.

**Five-Year Rule**

The rules for periodic adjustments of intangibles do not apply if the taxpayer meets the comparable exception requirements or the methodology other than the comparable uncontrolled transaction method. No periodic adjustments will be made in any subsequent year if the taxpayer meets either such method for each year of the five-year period. The year begins with the first year in which substantial periodic consideration was required to be paid. This exception to the periodic adjustment rule is an alternative to the “same intangible” rule, the “comparable intangible” rule, the “non-CUT” rule, and the “extraordinary events” rule.

Two examples illustrate the periodic adjustment rule:

**EXAMPLE**

A distributor licenses a drug from two manufacturers, one a related party, under the same terms. Although both transactions had been fully comparable, the drug produced by one of the manufacturers now shows slightly more promise. The periodic adjustment rules preclude future audit adjustments concerning that license.

**EXAMPLE**

The example is identical to the prior example except that the drug produced by one of the manufacturers shows substantially more promise. The periodic adjustment rules would not apply, and audits can ensue.

**APPLYING THE PERIODIC ADJUSTMENT RULE**

The transfer pricing provisions for intangibles include three examples that pertain to the periodic adjustment rule. The first two examples discuss a pharmaceutical company that has developed a new drug and focus on profit projections and actual profits. The third example discusses an extraordinary event and this exception to the periodic adjustment rule.

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EXAMPLE 1: PHARMACEUTICAL\textsuperscript{146}

The first example portrays the development and exploitation of a new drug. USdrug is a U.S. pharmaceutical company that has developed a new drug, Nosplit, which is useful in treating migraine headaches and has no significant side effects. Several other drugs for treating migraine headaches are on the market. These other treatments produce side effects. USdrug has assessed the future progress of Nosplit and has determined that Nosplit can be expected to rapidly dominate the worldwide market for migraine headache treatments. In addition, Nosplit is expected to command a premium price because all of the other treatments produce side effects. USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. and European markets.

USdrug establishes a new European subsidiary, Eurodrug. Then USdrug licenses Eurodrug the right to produce and market Nosplit for the European market for five years. USdrug projects annual sales revenue and annual profits to be derived from the exploitation of Nosplit by Eurodrug. This information is used in setting the royalty rate for the license. Although the regulations do not so indicate, cost projections would have to be made to determine annual profits from Nosplit. USdrug determines annual sales revenue, but the regulations do not indicate the mechanism to be used to determine the ultimate sales prices to the wholesaler, retailer, drugstore, or consumer. Based on these projections, a royalty rate of 3.9 percent is established for the term of the license.

Now we turn to the tax issues. In year 1, USdrug evaluates the royalty rate that it received from Eurodrug. Nosplit has high profit potential, and therefore USdrug is unable to locate any uncontrolled transactions that pertain to licenses of “comparable” intangible property. As a result, USdrug determines that the comparable uncontrolled transaction method (CUT) will not provide a “reliable measure” of an arm’s-length royalty; however, USdrug applies the comparable profits method (CPM) to Eurodrug and determines that a royalty rate of 3.9 percent will result in Eurodrug earning an arm’s-length return for its manufacturing and marketing functions. The example does not deal with application of the CPM to USdrug, but it would not have been feasible to apply the CPM method to USdrug because of the importance of its research and development activities.

The U.S. tax return for USdrug in year 5 is examined. The district director must determine whether the royalty rate between USdrug and Eurodrug is commensurate with the income that is attributable to Nosplit. The district director determines whether any of the exceptions to the periodic adjustment rules are applicable in making the royalty determination (i.e., the “same intangible” rule, the “comparable intangible” rule, the “non-CUT” rule, the “extraordinary events” rule, or the “five-year” rule). The district director compares projections and actual data in applying the exceptions. Profit projections that are attributable to Nosplit are compared with

\textsuperscript{146} Treas. Reg. § 1.482-4(f)(2)(iii), Example 1.
actual profits realized by Eurodrug. The projected profits and the actual profits are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit Projections</th>
<th>Actual Profits</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>200</td>
<td>250</td>
<td>50</td>
</tr>
<tr>
<td>2</td>
<td>250</td>
<td>300</td>
<td>50</td>
</tr>
<tr>
<td>3</td>
<td>500</td>
<td>600</td>
<td>100</td>
</tr>
<tr>
<td>4</td>
<td>350</td>
<td>200</td>
<td>-150</td>
</tr>
<tr>
<td>5</td>
<td>100</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1,400</td>
<td>1,450</td>
<td>50</td>
</tr>
</tbody>
</table>

The district director then applies the 80 percent/120 percent test, which is determined on a cumulative basis, up to and including the year under review. Total profits earned through year 5 are not less than 80 percent nor more than 120 percent of the profits that were projected when the license was entered into. If the district director determines that the other requirements of the non-CUT method were met, the non-CUT exception to the periodic adjustment rule applies. Accordingly, no adjustment to the royalty rate will be made between USdrug and Eurodrug for the license of Nosplit.

**EXAMPLE 2: PHARMACEUTICAL**

The second example is the same as the first except that Nosplit’s actual profits were much higher than prospective profits, as indicated here:

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit Projections</th>
<th>Actual Profits</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>200</td>
<td>250</td>
<td>50</td>
</tr>
<tr>
<td>2</td>
<td>250</td>
<td>500</td>
<td>250</td>
</tr>
<tr>
<td>3</td>
<td>500</td>
<td>800</td>
<td>300</td>
</tr>
<tr>
<td>4</td>
<td>350</td>
<td>700</td>
<td>350</td>
</tr>
<tr>
<td>5</td>
<td>100</td>
<td>600</td>
<td>500</td>
</tr>
<tr>
<td>Total</td>
<td>1,400</td>
<td>2,850</td>
<td>1,450</td>
</tr>
</tbody>
</table>

The district director considers the actual profits realized by Eurodrug in year 5 and in all past years in examining USdrug’s tax return for year 5. Years 1 through 4 might be closed under the statute of limitations. Nevertheless, the district director aggregates the actual profits from the prior years with the profits of year 5 to determine whether an adjustment should be made concerning the Nosplit royalty rate. The district director may make the adjustment, if any, only for year 5.

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EXAMPLE 3: MANUFACTURING PROCESS

The third example of the periodic adjustment exemption explores the potential for use of the “comparable intangible” exception to the periodic adjustment rule and the “extraordinary event” exception to the periodic adjustment rule.

Here, a foreign corporation, FP, licenses a new air-filtering process to its U.S. subsidiary, USS. The air-filtering process permits manufacturing plants to meet new environmental standards. The license between the parent and its subsidiary runs for a 10-year period. Profit derived from the air-filtering process is projected to be $15 million per year, an aggregate profit of $150 million.

With these facts, we can approach the tax issues. The royalty rate for the license is based on a “comparable intangible” under “comparable circumstances.” The regulations tell us that the requirements to the comparable intangible exception have been met. This exception includes five items: the controlled agreement, the uncontrolled agreement, similarity of the agreement, consistent use of the intangible, and no substantial changes in the functions performed. The following four activities apply in the illustration provided, indicating compliance with the comparable intangible exception to the periodic adjustment rule:

1. FP and USS have entered into a written agreement that provides for a royalty for each year of the license.
2. The royalty rate is considered arm’s length for the first taxable year in which a substantial royalty is required to be paid.
3. The license limits the use of the process to a specified field, consistent with industry practice.
4. No substantial changes were made in the functions performed by USS after the license was entered into.

Within the same example, we then look at the application of the extraordinary events exception to the periodic adjustment rules. The district director examines the license in year 4 and determines that the aggregate actual profits earned by USS through year 4 are $30 million, which is less than 80 percent of the projected profits of $60 million (projected profits were $15 million per year); however, USS provides an excuse for the difference based on extraordinary events. The example presupposes that functions in USS’s manufacturing plant concerning air-filtering process could be identified as such. USS establishes to the satisfaction of the district director that the aggregate actual profits from the process are less than 80 percent of the projected profits in year 3 because an earthquake severely damaged USS’s manufacturing plant.

The extraordinary events test is met. The periodic adjustment rules do not apply because the difference between the projected profits and the actual profits was a result of an extraordinary event that was beyond the control of USS. Moreover, the event could not have been reasonably anticipated at the time the license was entered into.

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OWNERSHIP OF THE INTANGIBLE PROPERTY

The special rules for intangible property delineate the ownership of the property in addition to focusing on the form of the consideration, periodic adjustments, artificial limits on the consideration, and lump sum payments. The ownership rules for intangible property identify the controlled taxpayer that should recognize the income attributable to the intangible property.

The transfer pricing regulations address both legally protected intangible property and intangible property that is not legally protected. The 1993 temporary regulations had provided that intangible property would generally be treated as owned by the controlled taxpayer that bore the greatest share of the costs of development. The 1994 final regulations made major changes from the earlier temporary regulations in identifying ownership of the property and focusing on legal ownership. Under the 1993 temporary regulations, a controlled taxpayer that is treated as the owner of the intangible might not in fact be the legal owner of the intangible.

Applying the Ownership Rules for Intangibles

The preamble explains the change in the ownership rules for intangibles in the following manner: The legal owner could transfer the rights to another person at arm’s length, irrespective of the developer’s contribution to the intangible; however, it is unlikely that at arm’s length an unrelated party would incur substantial costs to add value to an intangible owned by an unrelated party. The unrelated party might, however, incur these costs if there was some assurance that the party that incurred the expenses would receive the opportunity to reap the benefits attributable to the expenses.

The regulations embody what is termed by the preamble as a “modified approach” to identification of the owner of an intangible, which identification is based on legal relationships. Quite simply, the legal owner of the right to exploit the intangible is considered the owner. Legal ownership of the intangible does not relate solely to the registered holder of the intangible. In this regard, ownership rights may be transferred by either explicit or implicit agreement. Furthermore, more than one party may be considered a legal owner or have rights in the same intangible.

The transfer pricing regulations distinguish between the “owner” of the intangible and the “assister” that provides assistance to the owner of the intangible. These regulations speak of the “right to exploit the intangible” and of the “transfer of such rights” and determine the amount of consideration that the owner of the intangible is to receive for the transfer of these rights to a controlled taxpayer. The assister may be entitled to receive consideration for this assistance if it provides assistance to the owner in conjunction with development or enhancement of the intangible.

150 Preamble for Treas. Reg. § 1.482-4.
151 Id.
The right to exploit an intangible can be subdivided in various ways, as more than one party may be considered an owner of the intangible. As a result, a single intangible may have multiple owners. For example, the owner of a trademark may license to another person the exclusive right to use that trademark in a specified geographic area for a specified time. The owner of the trademark otherwise retains the right to use the intangible. In such a case, both the licensee and the licensor will be considered owners. Both parties, as owners of rights to the intangible, have rights to exploit the intangible. Similarly, a licensing agreement could grant the licensee a set of rights in the intangible for the duration of the agreement. This licensor could retain residual rights to the intangible after the agreement terminates.

**Legally Protected Intangible Property**

In many cases, it is difficult to identify the owner of the intangible. The determination of ownership is less difficult, however, when the intangible is legally protected. The legal owner of the right to exploit an intangible ordinarily will be considered the owner, but other overriding considerations may cause ownership of the intangible right to shift to another person. Thus legal ownership may be acquired by operation of law or contract under which the legal owner transfers all or part of its rights to another party.\(^{154}\)

The conduct of the parties determines ownership in many situations. The district director may impute an agreement to convey legal ownership of the intangible if the conduct of the controlled taxpayers indicates, in substance, the existence of an agreement. These imputed agreement provisions should apply both to oral agreements between the parties and to imperfectly written contracts, when such agreements are treated as valid by the parties.\(^{154}\)

**Intangible Property That Is Not Legally Protected**

The identification of the owner of an intangible is more difficult when the intangible property right is not protected. In that situation, the developer of the intangible is considered the owner.\(^{155}\) Two or more controlled taxpayers might jointly develop an intangible. Except for cost-sharing agreements, when there is joint development of an intangible, one (and only one) of the controlled taxpayers is regarded as the developer and owner of the intangible. Other participating members of the joint development are regarded as “assisters.”

**Largest Portion Test**

It may be difficult to delineate the activities and functions in the joint development of an intangible. In some situations, it is difficult to differentiate the activities that cause one participant to be the owner and other activities that cause the other participants to be assisters. The regulations “ordinarily” apply a “largest portion” test to determine the developer of the intangible.\(^{156}\) The presence of the

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\(^{154}\) Id.


\(^{156}\) Id.
term “ordinarily” in the regulation suggests that activities other than the “largest portion” may be taken into account in determining the developer of the intangible.

The “largest portion” of developing the intangible is determined on a quantitative basis. Both direct and indirect costs of developing the intangible are taken into account. “Direct costs” and “indirect costs” are not further defined in the transfer pricing regulation; however, these terms are defined in various international and domestic contexts, including those for Domestic International Sales Corporations and the apportionment of deductions. The “largest portion” test is amorphous because it includes activities that are “without adequate compensation” for the property or services that are “likely to contribute substantially” to developing the intangible. The nonmonetary provisions within the tax reporting rules for foreign-owned U.S. corporations should be relevant to this inquiry.

When ownership of the intangible is not legally protected, the owner is considered to be the person who bears the largest share of the costs of the intangible. This procedure was originally established in the 1993 temporary regulations.

The presence or absence of a reimbursement agreement can affect the status of the joint developer. In essence, the party that pays for the development is treated as the developer. A controlled taxpayer will be presumed not to have borne the costs of development if, pursuant to an agreement entered into before the project “is known,” another person is obligated to reimburse the controlled taxpayer for its costs. The “is known” requirement is troublesome because parties are unlikely to enter into an agreement before they know about the goals and purposes of the development.

**Determining the “Largest Portion”** In many situations, it will be difficult to determine which entity bears the “largest portion” of the development. If it cannot be determined which controlled taxpayer bears the largest portion of the costs of development, all other facts and circumstances will be taken into consideration, including the following:

- The location of the development activities
- The capability of each controlled taxpayer to carry on the project independently
- The extent to which each controlled taxpayer controls the project
- The conduct of the controlled taxpayers

**Assistance**

The regulations provide for allocations of assistance provided to the owner of the intangible in the context of the ownership rules for intangibles. Allocations may be

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159 Preamble for Treas. Reg. § 1.482-4.
161 Id.
made to reflect the arm’s-length consideration for the assistance in conjunction with
development or enhancement of the intangible. Assistance may include the following
activities:

- Loans
- Services
- The use of tangible property

“Assistance” is limited in scope, however, and does not include expenditures of
a “routine nature” that an unrelated party dealing at arm’s length would be expected
to incur under circumstances similar to those of the controlled taxpayer. The pre-
amble contains an example illustrating the “assistance” rule: A distributor may be
expected to incur a limited amount of advertising and other marketing expenses that
could increase the value of the trademark even if the licensor and licensee are unrel-
ated. This arrangement could take place even in the absence of a licensing agreement
transferring the right to exploit the trademark to an unrelated distributor. An uncon-
trolled taxpayer may incur such expenses without express or implied reimbursement
from the owner of the intangible; the same situation could apply to a controlled tax-
payer. No transfer pricing allocation will be made for a distributor that is a member
of the controlled group to which the legal owner of the trademark belongs. Never-
theless, an allocation could be made if the expenses were greater than those that an
unrelated party would have incurred without some form of compensation.

The term “routine nature” is not further defined by the regulations, but the term
connotes activities that are less than “ancillary or subsidiary services” in the DISC or
FSC context. In an era in which almost every activity is a profit center, the scope of
the “routine nature” provisions may be severely limited. Allocation of assistance is
to be determined under the regular transfer pricing rules.

**INTANGIBLE OWNERSHIP EXAMPLES**

The regulations provide four examples that illustrate the ownership rules for intan-
gible property.\(^{163}\)

**EXAMPLE 1**

**Intangible Ownership: Use of Tangible Property\(^{164}\)**

A and B are both members of a controlled group, and B is the owner of an intangi-
ble. A allows B to use its tangible property, such as laboratory equipment, in con-
nection with development of the intangible. B is the owner of the intangible, and A

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is the assister. Any allocation of expenses concerning “the owner’s use of the property” will be subject to the transfer pricing rules for the use of tangible property (i.e., the leasing rules). Despite ambiguous phraseology, the phrase “the owner’s use of the property” refers to A’s use of the laboratory equipment and other tangible items, not to B’s ownership in the intangible.

**EXAMPLE 2**

**Intangible Ownership: Nonreimbursed Expenses**

FP is a foreign producer of cheese, marketing cheese under the tradename Fromage Frere. FP owns all of the worldwide rights to that name. FP markets the cheese in countries other than the United States. Fromage Frere is widely known and is valuable outside the United States, but is not known within the United States.

In 1995, FP decides to enter the U.S. market and incorporates a U.S. subsidiary, USSub. The goal of this decision was to develop the name Fromage Frere in the United States. USSub will be FP’s U.S. distributor and will supervise advertising and other efforts consistent with the marketing decision.

USSub incurs expenses that are not reimbursed by FP for developing the U.S. market for Fromage Frere. The example does not indicate the magnitude of the expenses, except to state that these expenses are comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry. Expenses of independent distributors in the U.S. cheese industry are comparable to those of USSub for introduction of a product into the U.S. market under a brand name owned by a foreign distributor. USSub would have been expected to incur these expenses even if it were unrelated to FP. As a result, no allocation to USSub is made for marketing development activities performed by USSub.

**EXAMPLE 3**

**Intangible Ownership: Services Provided**

The facts are the same as in the prior example, except that the expenses incurred by USSub are significantly larger. USSub’s expenses are much greater than the expenses incurred by independent distributors under similar circumstances, and FP does not reimburse USSub for its expenses. The district director concludes, based on this evidence concerning nonreimbursed expenses, that an unrelated party would have requested reimbursement. An unrelated party dealing at arm’s length under similar circumstances would not have engaged in the same level of activity relating to the development of FP’s marketing intangibles without reimbursement.

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The basic level of expenses discussed in the prior example is not changed by the reimbursement provisions; however, expenditures in excess of the level incurred by the independent distributor are considered to be services provided to FP. The services add to the value of FP’s trademark for Fromage Frere. Accordingly, the district director makes a transfer pricing allocation for the fair market value of the services that USSub is considered to have performed for FP. As a practical matter, it will be difficult for both the IRS and the taxpayer to distinguish basic activities from excess activities.

EXAMPLE 4

Intangible Ownership: Shifting of Ownership Status

The facts in this final example of the ownership rules for intangibles are identical to the facts in the preceding example, except that FP and USSub conclude a long-term agreement. The example in the transfer pricing regulations does not specify the duration of the long-term agreement. Under this agreement, USSub receives the right to distribute cheese in the United States under FP’s trademark. USSub purchases cheese from FP at an arm’s-length price.

The drafters of the regulation implicitly conclude that the long-term distribution right in the FP-USSub agreement is an acquisition of legal ownership by contract. In essence, USSub becomes the owner of the trademark, and therefore USSub has legally protected intangible property. Furthermore, USSub’s conduct is consistent with the status of ownership. USSub is treated as the owner of the intangible for tax purposes, presumably starting with the date of the long-term contract. Accordingly, the activities of USSub are not considered to be a service performed for the benefit of FP; presumably such services include both the basic activities and the excess activities. The example from the regulations concludes that no allocation is made for these activities.

It appears that the parties can artificially shift income and expenses from one entity to another (e.g., from FP to USSub) through judicious timing of the long-term agreement for the intangible; however, taxpayers should be warned that repeated use of short-term agreements may cause the agreements to be tacked together as a long-term agreement.

LIMITS ON CONSIDERATION

The special rules for the transfers of intangible property limit the consideration amounts. The consideration limits apply in conjunction with four other provi-
LUMP SUM PAYMENTS

Lump sum payments are treated as advance payments for a stream of royalties. These provisions had been reserved in the 1993 temporary regulations. The regulations provide that lump sum payments are potentially subject to periodic adjustments to the same extent as licensing agreements that provide for periodic royalty payments. The provisions are part of the special rules for transfers of intangible property and are in addition to lump sum payment rules, which include the form of the consideration, periodic adjustments, ownership of the intangible property, and limits on consideration.

In general, if an intangible is transferred in a controlled transaction for a lump sum, the amount of the transfer must be “commensurate with the income” that is attributable to the intangible. Timing of the amounts are based on the taxpayer’s taxable year. A lump sum is commensurate with the income in a taxable year if “the equivalent royalty amount” for that taxable year is equal to an arm’s-length royalty. Most notably, the regulations speak of “an” arm’s-length amount rather

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\[169\] Preamble for Treas. Reg. § 1.482-4.
\[171\] Treas. Reg. § 1.482-4(f)(5).
\[172\] Preamble for Treas. Reg. § 1.482-4.
\[174\] Id.
than “the” arm’s-length amount, thus suggesting that there could be more than one arm’s-length amount.

The “equivalent royalty amount” for a taxable year is the amount determined by treating the lump sum as an advance payment for a stream of royalties. The stream of royalties is based on the useful life of the intangible, or the period covered by the agreement, if shorter. In many situations, it is difficult to determine the useful life of an item of intangible property. The regulations provide limited guidance within that context but specify that the useful life of the intangible reflects the projected sales of the licensee as of the date of the transfer. As such, the lump sum method places inordinate emphasis on the process of developing projections.

The determination of the equivalent royalty amount requires a present value determination. The factors that determine present value are the lump sum, an “appropriate discount rate,” and the projected sales over the relevant period. The regulations do not define an appropriate discount rate, nor do they establish parameters to determine this rate. The example in the regulations refers to a discount rate based on the riskiness (which is not further defined) of the business.

The equivalent royalty rate is not fixed in time. Rather, the equivalent rate is subject to periodic adjustments to the same extent that an actual royalty payment pursuant to a licensing agreement would be adjusted; however, a periodic adjustment will not be required if any of the exceptions to periodic adjustment rules apply: the “same intangible” rule, the “comparable intangible” rule, rules for non-CUT methods, the “extraordinary events” rule, or the “five-year period” rule.

A set-off is permitted. If a periodic adjustment is made, the royalty amount that is deemed prepaid for the taxable year in question will be set off against the arm’s-length royalty amount determined for each year. The difference will be treated as an additional payment in the year of the allocation that is in the same character as the initial lump sum payment.176

APPLYING THE LUMP SUM PAYMENT RULE

The regulations provide one example that illustrates both the lump sum payment provisions and the calculation of the equivalent royalty amount. Here FSub is a foreign subsidiary of USP, a U.S. company. USP licenses to FSub, for a period of 5 years, the right to produce and sell the whopperchopper, a patented new kitchen appliance, in the foreign market. Payment takes the form of a lump sum charge of $500,000 that is paid at the beginning of the period.

The example indicates that the equivalent royalty amount for the whopperchopper license is determined by deriving an equivalent royalty rate. The equivalent royalty rate is equal to the lump sum payment divided by the present discounted value of FSub’s projected sales of whopperchoppers over the life of the license—five years.

175 Id.
In the example, the “appropriate” discount depends on the riskiness of the whopperchopper business. Under this fact pattern, the appropriate discount rate was determined to be 10 percent. The example does not specify the risk factors that are considered to be relevant, the means of assessing risk, or the baseline or basic discount rate for a risk-free investment from which all risks should be measured.

The lump sum payment process is applied in the following manner:

- The company determines its projected sales amounts for each year.
- The sales amounts (which are determined in item 1) are discounted to present value.
- The present values for each year (determined in item 2) are totaled.
- The royalty rate is the lump sum payment divided by the total of the present values of the sales amounts (as determined in item 3).
- The equivalent royalty amount is determined by multiplying the projected sales amount times the royalty rate (as determined in item 4).

In the whopperchopper example, the projected sales for each year of the license are indicated in the second column, and the equivalent royalty amounts are reflected in the third column.

<table>
<thead>
<tr>
<th>Year</th>
<th>Projected Sales ($)</th>
<th>Discounted Amount (10%)</th>
<th>Equivalent Royalty Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2,500,000</td>
<td>2,272,727</td>
<td>125,000</td>
</tr>
<tr>
<td>2</td>
<td>2,600,000</td>
<td>2,148,760</td>
<td>130,000</td>
</tr>
<tr>
<td>3</td>
<td>2,700,000</td>
<td>2,028,550</td>
<td>135,000</td>
</tr>
<tr>
<td>4</td>
<td>2,700,000</td>
<td>1,844,136</td>
<td>135,000</td>
</tr>
<tr>
<td>5</td>
<td>2,750,000</td>
<td>1,707,533</td>
<td>137,500</td>
</tr>
<tr>
<td>Total</td>
<td>13,250,000</td>
<td>10,001,706</td>
<td>662,500</td>
</tr>
</tbody>
</table>

The discount amount, as computed by the regulations, determines the discount at the end of each year, so that the discount factors are 1.1, 1.21, 1.331, 1.4641, and 1.61051. The total, as thus determined, is $10,001,706. The regulations refer to the total discount amount as “approximately $10 million.” The royalty amount (lump sum payment divided by the total of the discounted amounts) is $500,000 divided by $10,001,706 or 4.9991471 percent. The regulations refer to the royalty rate as “approximately 5 percent.” The 5 percent rate is used to determine the equivalent royalty amount. Note that the equivalent royalty amount exceeds the lump sum amount because of the discounting process.

The IRS may require a periodic adjustment of the royalty if, in any of the 5 taxable years, the equivalent royalty amount is determined not to be an arm’s-length amount; however, the exceptions to the periodic adjustment rule may be available for lump sum payments. If the royalty amount is adjusted, the amount is equal to the difference between the equivalent royalty amount and the arm’s-length royalty in that taxable year.
PLANNING OPPORTUNITIES

Review all transfers of intangibles. Many intangibles may be amorphous, ephemeral, and uncertain, and many licenses may be at zero. Start with each right granted by one party to another before estimating the value of the intangible.

EXAMPLE

Company M develops a distinctive trade dress for a line of industrial products, embodying size, texture, graphics, color combination, and total image. These rights were transferred de facto to its subsidiaries, but the rights were not viewed by the company as an asset and no amounts were charged. The arm’s-length royalty is $1 million. In addition to the allocation, Company M is subject to a $400,000 penalty.

CONCLUSION

The substantially revised transfer pricing regulations for intangibles may have eliminated some of the large controversies with which taxpayers, tax professionals, and the IRS have been plagued. Nevertheless, the final regulations have created a myriad of smaller but even more important tax issues.
OVERVIEW

Under Section 482 of the Internal Revenue Code (IRC), the Internal Revenue Service (IRS) has authority to allocate income among members of a controlled group to reflect an arm’s-length charge for marketing, managerial, administrative, technical, and other services. Given the increasing importance of services in the world economy, and the volume of intercompany services performed within multinational groups, it is perhaps surprising that the body of law applicable to the transfer pricing of services is quite small. The transfer pricing of services has received far less attention by the IRS than transfer pricing for sales of tangible property or licensing of intangible property, although extensive guidance in the form of proposed IRS regulations was said to be imminent at the time of this writing. Applying the arm’s-

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1 All section references are to the Internal Revenue Code or to the regulations promulgated thereunder.
2 Treas. Reg. § 1.482-2(b)(1).
3 As this book was going to press, Treasury and the IRS released proposed regulations under section 482 addressing the treatments of controlled services transactions (the “Proposed Regulations”). 68 Fed. Reg. 53448 (Sept. 10, 2003). The Proposed Regulations also amend existing regulations addressing the allocation of income from intangibles when a controlled party contributes to the value of an intangible owned by another controlled party. See Treas. Reg. § 1.482-4(f)(3)(i). The Proposed Regulations are proposed to be effective for taxable years beginning on or after the date that final regulations are published in the Federal Register. Prop. Treas. Reg. § 1.482-9(n).

An objective of the Proposed Regulations is to conform the methods applicable to transfer pricing for services with the methods applicable to tangible or intangible property. In addition, the proposed Regulations replace the cost safe harbor of the current regulations with a new “simplified cost-based method” applicable only to low-margin controlled services transactions that meet certain quantitative and qualitative conditions and requirements, including the following: (1) the transaction must not be an excluded transaction (such as manufacturing, production extraction, construction, reselling or distribution or acting as a sales or purchasing agent or acting under a commission or similar arrangement), (2) the arm’s-length mark-up of costs must not exceed 10 percent, (3) the taxpayer must maintain adequate books and records, (4) the renderer and the recipient must not render, or have rendered, similar services to

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CHAPTER 8

Transfer Pricing for Services

By Kenneth Klein and Philip Karter
length standard to services can be difficult because of the typical absence of third-party comparable transactions. When comparables exist, adjustments for differing circumstances typically must be made.

In many cases, the performance of a service may simultaneously involve the utilization, or transfer, of tangible or intangible property. Complexity can arise in determining the value attributable to the property or the service, as the case may be. For example, a research service may utilize substantial laboratory equipment, a transportation or construction service may utilize heavy equipment, a commission service may utilize know-how or software, or a sale of goods may be accompanied by related services.

In many cases, the arm’s-length value of services need not be determined at all. Rather, the primary question is simply to which corporate entity in the controlled group the particular expense should be allocated. In some cases, the value of a service performed by a related corporation may be little more than a small markup on the costs of the corporation, especially the employee costs. Often the affiliate could just as easily have operated in branch form. In other cases, because of the absence of close comparables, the appropriate arm’s-length price may be the same markup on costs as that generated by companies performing services that are quite different from those performed by the taxpayer.

uncontrolled parties, (5) a detailed written contract covering the services must be in place (subject to a de minimis exception), (6) the aggregate amount paid by the recipient to the renderer must not exceed 50 percent of the total costs, without materials, included in the cost of sales of the recipient, and (7) the renderer’s valuable or unique intangible property or the renderer’s particular resources or capabilities must not contribute significantly to the value of the service. Prop. Treas. Reg. § 1.482-9(f).

Unlike the current regulations, the Proposed Regulations specifically permit the use of five other transfer pricing methods (subject to the best method rule), which are analogous to methods applicable to tangible and intangible property under the current regulations. Prop. Treas. Reg. § 1.482-9(a). The comparable uncontrolled services price method is analogous to the comparable uncontrolled price method and compares the price of a controlled services transaction with the price charged in a comparable uncontrolled services transaction. Prop. Treas. Reg. § 1.482-9(b). The gross services margin method is similar to the resale price method and evaluates the price charges in controlled services transaction by reference to the gross services profits margin realized in uncontrolled transactions involving similar services. Prop. Treas. Reg. § 1.482-9(c). The cost of services plus method is similar to the cost plus method and evaluates whether the amount charged in a controlled services transaction is arm’s length by reference to the gross services profit markup in comparable uncontrolled transactions. Prop. Treas. Reg. § 1.482-9(d). The comparable profits method applies the rules of Treasury regulations section 1.482-5 (with certain modifications) to evaluate whether the amount charged is arm’s length based on an analysis of objective measures of profitability (profit level indicators) derived from financial information regarding uncontrolled taxpayers that engage in similar business activities under similar circumstances. Prop. Treas. Reg. § 1.482-9(e). The profit split method applies the rule of Treasury regulations section 1.482-6 and evaluate whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm’s length by reference to the relative value of each controlled taxpayer’s contribution to that combined operating profit or loss. Treas. Reg. § 1.482-9(g).
CHARACTERIZATION CONSIDERATIONS

As with most tax issues, it is extremely important in determining transfer pricing for services to first characterize the relevant transactions and to consider their tax implications before attempting to apply the relevant regulations and case law. All aspects of a transaction and related transactions must be analyzed. Basic questions must be asked, such as the following:

- Who is doing what for whom?
- Where are they doing it?
- Why are they doing it?
- How are they doing it?
- What property is being used or transferred in connection therewith?

Such an analysis typically provides key information about what services are being performed and the pricing thereof. Taxpayers and the IRS often disagree regarding whether a service is being performed and, if so, what an arm’s-length price for the service should be.

In *Nat Harrison Associates, Inc. v. Commissioner*, the taxpayer maintained that its offshore affiliate performed substantial services. The IRS was able to prove that Harrison’s domestic affiliate was entitled to a profit for various services, including purchasing materials, negotiating change orders, and assuming contract risks.

Similarly, in *Hospital Corporation of America v. Commissioner*, the taxpayer was able to show that a foreign affiliate deserved a profit for what it did. The court held that the domestic parent had earned a profit for a variety of services it performed on the foreign affiliate’s behalf, including negotiating a contract, providing a guarantee, formulating a staffing plan, ordering supplies and equipment, and performing other services.

In *Diefenthal v. United States*, the foreign corporation was able to justify a profit by showing that it had assumed a significant risk when it time-chartered vessels in and voyage-chartered vessels out. At the same time, the company minimized the value of ancillary services performed by its domestic affiliate.

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5 81 T.C. 520 (1983).
6 While the court in HCA appeared to treat a guarantee as a service, as has the Service (see, e.g., G.C.M. 38499 (Sept. 19, 1980), P.L.R. 7822005 (Feb. 22, 1978), and TAM 771228960A (Dec. 28, 1977)), in Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982), the Court of Claims sourced income from a guarantee-like transaction by analogy to the sourcing of interest income (rather than as service income). See also Centel Communications Co. v. Comm’r, 92 T.C. 612 (1989), aff’d, 920 F.2d 1335 (7th Cir. 1990) (guarantee under § 83).
IMPLEMENTING THE SERVICES—PROPERTY DISTINCTION

The preliminary analysis can become especially confusing when transfers of property, as well as services, take place. The Tax Court found in HCA and in Nat Harrison Associates that the domestic affiliate was entitled to a profit for other items that probably are not viewed as services, but as the transfer or use of property. Such activities included the provision of personnel, systems, expertise, and experience (HCA) and the transfer of the right to profits and the use of facilities (Nat Harrison). In HCA, the IRS argued that intangible property had been transferred to the foreign affiliate in a taxable transaction (because of the absence of an outbound Section 367 ruling) and that services had been performed in a taxable exchange for stock.

The 1988 “White Paper” stated that intangibles could be transferred in the form of services by “loaning” key employees to a foreign affiliate, thereby simultaneously providing services and transferring know-how. Ciba-Geigy Corp. v. Commissioner primarily involved the correct royalty rate for a transfer of intangibles. In this case, the court also upheld or rejected proposed allocations for related services in connection with field testing, parallel screening, and the registration of patents in the United States. Courts have differentiated between services and property, but not necessarily in a crisp manner. Because of apparent IRS concerns that intangibles in some cases can be transferred through the performance of services, it is expected that forthcoming regulations will address this issue in greater depth than currently is the case, as discussed in the following section.

ANCILLARY AND SUBSIDIARY SERVICES

When intangible property is transferred, and services are rendered in connection therewith, the IRS generally requires two separate transfer pricing analyses: one for the services and another for the property. When the service rendered is “merely ancillary and subsidiary” to the transfer of the property or the commencement of the effective use of the property, however, a separate allocation for services may not be made. Still, such services may affect the appropriate transfer price of the property. In effect, consideration may have to be given to the pricing of the service.

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11 Treas. Reg. § 1.482-1(b)(2)(i). Transactions involving related products or services may be aggregated pursuant to Treas. Reg. § 1.482-4(f)(2)(i).
12 Treas. Reg. § 1.482-2(b)(8).
13 Treas. Reg. § 1.482-2(b)(8).
Whether the services are merely ancillary and subsidiary is a question of fact. Ancillary and subsidiary services can be performed in promoting a transaction by demonstrating and explaining its use, or by assisting in the effective “starting up” of the property transferred, or by performing under a guarantee relating to such effective starting up.\textsuperscript{15} When an employee reveals a secret process owned by the employer and at the same time supervises the integration of the process into the manufacturing operation of the related person, the services are considered to be rendered in connection with the transfer, and are not the basis for a separate allocation.\textsuperscript{16}

In a buy–sell property situation, when the buyer–reseller takes title to goods, the regulations acknowledge that there can be circumstances when the profit to be derived by the buyer–reseller should be comparable to that of a commission sales agent that does not take title to goods.\textsuperscript{17} This situation could occur when the buyer–reseller has no risk of loss from the sales price of the property. Thus, for example, the buyer–reseller would be deemed to earn a gross profit margin equivalent to the percentage the commission represents of the uncontrolled sales price of the goods involved.

**COLLATERAL CONCERNS**

In addition to an extensive analysis of considerations affecting services, one must also take into account other tax consequences besides transfer pricing. For example, the following types of questions need to be asked:

- If a foreign corporation performs services in the United States for a U.S. affiliate, is the foreign corporation engaged in a U.S. business, does it therefore derive U.S. source income, and is it consequently subject to U.S. taxation?
- Can the activities of a U.S. affiliate performing services for a foreign affiliate cause the foreign affiliate to be engaged in business and subject to U.S. tax?\textsuperscript{18}
- If a foreign corporation engaged in the sale of manufactured goods, or in trading stocks and securities, has a U.S. affiliate that finds customers or otherwise assists in the foreign corporation’s business, does the U.S. affiliate constitute an agent whose activities are attributed to the principal so as to subject the foreign affiliate to U.S. taxation?
- What is the relevance of tax treaties in this regard, both for regular tax and for branch profits tax purposes?

\textsuperscript{15} Treas. Reg. § 1.482-2(b)(8).
\textsuperscript{16} Id.
\textsuperscript{17} Treas. Reg. § 1.482-3(c)(3)(ii)(D).
Do services performed outside the United States by a foreign affiliate for a U.S. corporation cause foreign tax exposure for the U.S. corporation?

What is the source of the services income for foreign tax credit purposes?

The potential tax consequences of these and other considerations could in many cases be of far greater magnitude than the transfer pricing tax exposure. For example, the source of services income (other than certain transportation and other income) generally is where the services are performed. U.S. source services income can be subject to tax in the hands of a foreign corporation (under IRC Section 882 and Section 884) and can have detrimental or favorable foreign tax credit implications for U.S. taxpayers, depending on how deductions are allocated under IRC Section 904.

The rest of this chapter is divided into three sections. The first section looks at an important threshold question—for whose benefit is an expense incurred? Once it is determined who the expense belongs to, the next section examines when, under the regulations, an arm’s-length charge under IRC Section 482 can be deemed equal to the cost of performing the service. When the cost of performing the service is not deemed to be the arm’s-length charge, the third section then examines the regulatory and case law standards for determining what the arm’s-length price for the service should be.

The 1988 White Paper precipitated tax changes and the lack of other tax changes. The White Paper was followed in early 1992 with proposed Section 482 regulations, and again in early 1993 with proposed and temporary Section 482 regulations, all taking a somewhat different approach to the “commensurate with income” standard applicable under Section 482 to transfers of intangibles. The preamble to the 1992 proposed Section 482 regulations invited public comment on how the IRS’s regulations should incorporate the “commensurate with income” standard. The 1993 proposed and temporary regulations did not substantively amend the IRS regulations. The regulations were finalized in 1994, although the services regulations have remained substantially the same since their introduction in 1968.

**WHOSE EXPENSE IS IT?**

**Initial Inquiry**

An important initial inquiry in transfer pricing for services is determining for whose benefit an expense is incurred. It is quite common for one company to incur an

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19 See I.R.C. §§ 861(a)(3), 862(a)(3), 863(b), 863(c), 863(d), and 863(e).
expense that benefits itself as well as one or more other affiliates. Expenses must be allocated in such a situation. The IRS could require an allocation to reflect an arm’s-length charge, whether the arm’s-length charge is cost or fair market value. Such expenses could be incurred for services performed for the benefit of the company incurring the expense, for the benefit of another member of the group, or for the joint benefit of more than one member of the group.

Allocations are to be consistent with the relevant benefits intended for the services, based on the facts known when the services were rendered, and not based on benefits realized. Allocations are not to be made, according to the regulations, if the probable benefit to other members is so indirect or remote that unrelated parties would not have charged for the services. The regulations indicate that allocations may be made if the service, at the time performed, relates to the carrying on of an activity by another member of the group, or if it is intended to benefit the other member of the group.22

Allocating Benefits

The regulations provide several illustrations of this rule. In one example, an international airline has an affiliate that operates hotels in cities serviced by the airline. The airline’s advertising brochure mentions the hotel affiliate and includes pictures of its hotels. The regulations indicate that the airline’s advertisement is reasonably anticipated to be a substantial benefit to the hotel affiliate and, as a result, a Section 482 allocation is deemed appropriate. If, however, the airline does not directly mention the hotel affiliate’s name or include pictures of its hotels, the regulation indicates that an allocation is not appropriate, even though the hotel affiliate may benefit from the advertising. Here the probable benefit was so indirect and remote that an unrelated hotel operator would not have been charged.23

Stewardship

Allocations are generally not made if the service is merely a duplication of the service that the related party has independently performed or if the service is performed by the corporation for itself.24 Stewardship expenses are illustrated in the regulations in the context of a financial analysis for a subsidiary’s borrowing needs. When the subsidiary does not have personnel qualified to make the analysis, and does not make the analysis, the cost of the financial analysis done by the parent is required to be allocated to the subsidiary. If, however, the subsidiary has a qualified financial staff and makes the analysis, the review of the analysis by the parent’s financial staff is duplicative, and a Section 482 allocation is not made.25

The determination of whether an expense is a stewardship expense is also relevant in applying the expense allocation rules for foreign tax credit and other pur-
poses. Characterization as a stewardship expense generally results in an allocation of expenses to dividends received (or to be received) from the corporation whose activities are being supervised.\textsuperscript{26}

The question of whether an expense is for the benefit of the parent, whether as a duplication or as a supervision of its investment in a subsidiary, can be a very difficult one. Almost any parent activity that relates to a subsidiary can benefit the subsidiary, thereby becoming potentially subject to an allocation between these two categories. It is by no means clear where the line occurs between stewardship activities, for which an allocation is not to be made, and nonstewardship activities benefitting the subsidiary, for which an allocation is to be made. It is also unclear as to how expenses are to be allocated when they are for the benefit of more than one party. These issues are addressed in following sections. Finally, it is not clear whether a stewardship expense can arise from an activity involving a related corporation as opposed to a subsidiary in which the corporation has an investment.\textsuperscript{27}

\textbf{Columbian Rope}

Two cases decided in the 1960s, \textit{Columbian Rope Co.} and \textit{Young \& Rubicam}, provided some guidance in identifying the recipient, the party for whom the expense is incurred. The cases did not involve an interpretation of the existing Section 482 regulations, but raised the issue whether IRC Section 162 could be applied to disallow expenses incurred by a parent when the expenses were incurred for the benefit of a subsidiary.

The parent corporation incurred expenses for executives who were employees of its foreign subsidiary. The deduction was disallowed by the Tax Court in \textit{Columbian Rope Co.} \textit{v. Commissioner},\textsuperscript{28} even though the parent could benefit from the success of the subsidiary. The court permitted the parent to deduct certain other expenses the IRS had disallowed. Included among these deductions were expenses for executives of the parent who oversaw the activities of the subsidiary. The court found that the expenses were deductible by the parent because they were for supervisory services “which would be an ordinary and necessary part of their duties in conducting and managing [the parent’s] . . . business.”

\textbf{Young \& Rubicam}

\textit{Young \& Rubicam, Inc.} \textit{v. United States}\textsuperscript{29} involved both a disallowance of expenses under Section 162 and a Section 482 allocation. The Claims Court analyzed the activities of various employees of a parent corporation and did not permit a deduction when the expenses were for the benefit of the subsidiary and not the parent. The court partially disallowed expenses when the expenses were for the benefit of both the parent and the subsidiary. In doing so, the Claims Court indicated that a com-

\textsuperscript{26} See Treas. Reg. §§ 1.861-8(e)(4) and 1.861-8(g), Examples 17 through 21.
\textsuperscript{27} See Treas. Reg. §§ 1.482-2(b)(2), 1.861-8(e)(4), and 1.861-8(g), Examples 17 and 18.
\textsuperscript{28} 42 T.C. 800 (1964), \textit{acq.} 1965-1 C.B. 4.
\textsuperscript{29} 410 F.2d 1233 (Ct. Cl. 1969).
pany cannot claim compensation paid for activities concerning the day-to-day operation of its subsidiary’s business as its own expense. The court stated that any “benefit . . . from these activities cannot be considered proximate and direct to its own business and, therefore, these expenses are not allowable deductions under Section 162.” The court did not believe that the expenses benefiting the subsidiaries provided a sufficiently proximate benefit to the parent to permit it to deduct the expenses.

Young & Rubicam also concerned a proposed Section 482 allocation from foreign subsidiaries to the U.S. parent for the value of managerial services purportedly performed for the subsidiaries by executives of the parent. The court assumed that the expenses for the salaries were deductible and looked at whether the employees were performing supervisory services for the parent or managerial services for the subsidiary.

Services involved visits by executives to foreign subsidiaries to negotiate with clients of the foreign subsidiaries that were threatening to terminate their relationships with the subsidiaries. Other services pertained to troubleshooting activities for the foreign subsidiaries. The executives visited subsidiaries to deal with the subsidiaries’ personnel issues as well. Executives also visited various customers, encouraging them to hire their subsidiaries in their particular markets.

In these cases, the court held that the functions performed were supervisory functions performed by executives of the parent’s “International Division” and for promoting additional foreign expansion. These functions were not viewed as management services. Consequently, the proposed Section 482 allocation was not upheld.

The Young & Rubicam case suggests a broad interpretation of the concept of supervisory or stewardship expenses. One might have thought that many of the activities of the executives were either primarily for the benefit of the subsidiaries or jointly for the benefit of the parent and the subsidiaries. Although the success of the subsidiaries clearly benefited the parent, the success seemed to have been a direct benefit to the subsidiaries. The presence of the executives as part of the parent’s International Division was important to the court because they were charged with the international activities of the company. The Section 482 holding in the case can be difficult to reconcile with a plain reading of the regulations, which did not apply to the taxable years at issue in Young & Rubicam, and with the benefit rule of TAM 8806002, discussed next.

Benefit Rule

The IRS provided an extensive analysis of the “benefit rule” in a 1987 technical advice memorandum, TAM 8806002. The ruling pertained to A, a domestic corporation, with numerous foreign subsidiaries (referred to as XYZ corporations). A operated a European branch (Branch B) that rendered substantial management services to XYZ. Among the services Branch B performed for XYZ were legal services,
administrative services, controller, treasurer, manufacturing and engineering strategy, material management, marketing services, and personnel policy services. Seventy-five percent of Branch B’s activities were allocated by the taxpayer to XYZ, and the remaining 25 percent were characterized as “control activities” or stewardship expenses. The International Examiner concluded that only 8 percent of the activities were stewardship activities, and the remaining 92 percent should have been allocated to XYZ.

TAM 8806002 approached the issue by categorizing the services rendered into four distinct classes. Class I included expenses for the direct benefit of one or more of the subsidiaries in which the parent might receive an indirect benefit. The preparation of intercompany pricing matters between A’s subsidiaries might enable it to avoid undesirable domestic tax consequences that would otherwise result from the application of Section 482 and the subpart F rules. This situation was an example of Class I expenses.

Class II included expenses that were stewardship expenses, such as expenses incurred in preparing the U.S. tax return or information report filings with the IRS or the Securities and Exchange Commission (SEC). Also included were periodic reviews of, and visits to, the foreign subsidiaries by management, meeting legal requirements of the parent, and financing or refinancing the parent’s interest in the subsidiary.

Class III expenses were for the benefit of the entire affiliated group, such as those incurred in the process of securing financing for the operating capital needs of the group, even when some of these subsidiaries did not need to borrow.

Finally, Class IV expenses were expenses of the parent that are not stewardship expenses, such as expenses associated with investigating new business opportunities, which bear no relationship to the trade or business activities of the existing members of the group. According to the IRS, these expenses are not properly characterized as stewardship expenses because they do not relate to a current investment of the parent in its existing subsidiaries.

After defining the various categories of expenses, the TAM attempted to place each expense within a category. According to the IRS, expenses grouped in Class I or III should be charged to the subsidiaries under the general principles of the benefit test. Expenses within Class II and IV are deductible expenses of the parent.

The benefit test, as general in nature, according to the TAM “does not always produce clear definitive answers in some situations involving overlapping benefits, indirect benefits and remote benefits.” The TAM purported to apply a Young & Rubicam “proximate and direct” standard to the benefits test to determine which expenses constituted stewardship expenses of the parent as opposed to operating expenses of the subsidiaries.

In an interesting example of the “proximate and direct” standard, a parent report on the foreign subsidiaries’ assets was needed for an SEC filing; however, the subsidiary needed a substantially similar report for a property tax return in the foreign country. The report was prepared by an employee of the parent, who devoted two hours to the SEC report, two hours to the foreign country return, and the four-hour remainder on both reports. The two sets of two hours needed for the SEC and foreign returns were both viewed as direct and proximate to the parent and the sub-
sidiary. The parent’s benefit from the foreign country report was viewed as being indirect. The four hours devoted to the remaining portion of the report was viewed as being a direct benefit to both.

Because the foreign report was due first, however, the effort was allocated to the foreign subsidiary. The benefit to the parent was viewed as remote. Apparently, if the timing had been reversed, the expense would have been allocated to the parent and the subsidiary would have been viewed as receiving remote benefit. Assuming that the timing was reasonably close, it is unclear why the expense should not have been allocated to both.

TAM 8806002 indicates that keeping books and records by a foreign subsidiary enables the U.S. parent to comply with information return filing requirements and other U.S. purposes, and saves the parent expense that it would otherwise have to incur; however, the benefits to the parent of the subsidiary’s accounting expenses are remote and are not to be allocated to the parent.

TAM 8806002 provides useful guidance on various aspects of identifying the parts for which the benefit of an expense is incurred. This test is factual, and it is not clear that the TAM is entirely consistent with Young & Rubicam, which seemed to contemplate a very broad scope of supervisory or stewardship expenses. The TAM suggests that more attention would be paid by the IRS than appeared to be the case in Young & Rubicam to whether the expense benefits both a parent and a subsidiary and thus should be allocated between them. Certain broad language in the general description of Class I and Class IV expenses can be interpreted as being consistent with Young & Rubicam, but, expenses such as those in Young & Rubicam, which involve troubleshooting for foreign subsidiaries’ clients’ accounts, were not presented for discussion in the TAM.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (the OECD Transfer Pricing Guidelines for MNEs),32 in its discussion of the rules regarding transfer pricing rules for services, proposes that the rules create a distinction between conventional stewardship activities and those related-party services that are provided by a parent to its affiliate in the capacity as a shareholder of the affiliate. These so-called shareholder activities, the OECD Transfer Pricing Guidelines for MNEs notes, are different from the types of expenses incurred by a parent in overseeing its investment in a subsidiary. Examples of activities the OECD would define as nonstewardship shareholder activities are a corporate parent’s responsibilities to comply with corporate and securities law requirements such as issuing annual meeting notices, activities in which the parent is fulfilling its consolidated reporting requirements, and activities in pursuing acquisition targets.

Although the OECD proposes a regulatory formalization of the distinctions between stewardship expenses and shareholder activities, the rationale for such a distinction is not readily apparent because either type of expense should not precipitate a reallocation. In fact, the examples cited by the OECD Transfer Pricing Guidelines for MNEs of shareholder activities are similar in nature to those defined as Class II

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and Class IV expenses by TAM 8806002, which the IRS concluded may properly be deducted by the parent without reallocation.

**Allocation Methodologies**

In addition to the lack of clarity with respect to whose benefit an expense is incurred, the law is unclear regarding the proper method of allocating and apportioning deductions among taxpayers when the expense is for their joint benefit. Clearly, if an expense benefits only one member, that expense should be allocated to such member. When the arm’s-length charge is based on costs and deductions, and a member has allocated and apportioned costs using a consistent method that is reasonable and in keeping with sound accounting practice, the regulations provide that the method is not to be disturbed. Otherwise, the determination is to be based on the circumstances.\(^{33}\)

The regulations do not give any real guidance on specific methodologies but indicate that the use of one or more bases may be appropriate. Appropriate consideration must be given to all bases and factors, including, for example, total expenses, asset size, sales, manufacturing expenses, payroll, space utilized, and time spent. Costs incurred by supporting departments can be apportioned to other departments on the basis of a reasonable overall estimate, or such costs may be reflected by means of application of reasonable departmental overhead rates.

Allocations are to be made on the basis of the full cost, rather than incremental cost. If a computer rented by the taxpayer is used for the joint benefit of the member and other members of a control group, the determination of the arm’s-length charge must be made with reference to the full rent and cost of operating the machine by each member. Full cost is to be used even if the additional use of the machine for the benefit of other members does not increase its cost to the taxpayer.\(^{34}\)

These bases and factors suggest that there is some flexibility and that a rule of reason applies. Presumably, the taxpayer should be able to show some reasonable relationship between the base or factor used and the result. Practices used to apportion expenses can be considered by the IRS if the activities are in connection with the preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies. Apportionment practices used by domestic members of a group can be considered in comparable circumstances when an allocation is to be made to foreign members of the group.\(^{35}\)

**WHEN ARM’S LENGTH CAN EQUAL COST**

**Permissive Use of Cost under Regulations**

Determining an arm’s-length price can be quite difficult for services. A taxpayer is entitled to treat the arm’s-length price as equal to the costs or deductions incurred for

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\(^{33}\) Treas. Reg. § 1.482-2(b)(6)(i).

\(^{34}\) Treas. Reg. § 1.482-2(b)(6)(ii).

\(^{35}\) Treas. Reg. § 1.482-2(b)(6)(iii).
the services, unless the taxpayer establishes a more appropriate price that would have been charged for the same or similar services in independent transactions between unrelated parties under similar circumstances considering all relevant facts. Many U.S. and foreign multinationals, after engaging in the previously discussed benefit analysis, simply use the expenses and costs, as allocated, for income tax return purposes. This procedure saves them the expense and effort of determining an arm’s-length charge. The costs and expenses that are taken into account in this regard are discussed in a following section.

Utilization of cost or expense is permitted, but the taxpayer is not required to use the method. A taxpayer’s economic interest could be to determine a fair market value arm’s-length charge, so as to increase the amount of expenses that are deductible in one jurisdiction (e.g., a high-tax jurisdiction), or increase the amount of income taxable in another jurisdiction (e.g., a low-tax jurisdiction).

The use of cost without any adjustments is not permitted if the services are “an integral part of the business activity of a member of a group of controlled entities.” Detailed rules are provided for making this determination, as with most of the other tests discussed previously; however, the rules are often based on factual or subjective determinations. There is often no certainty as to whether the service would be viewed as meeting the integral business activity test. The four types of situations in which services are considered an integral part of the business activity are discussed as follows.

**Neither Renderer nor Recipient in Business of Servicing Unrelated Persons**

The first situation in which cost cannot be used and a fair market value arm’s-length charge can be mandated by the IRS is when the services are an integral part of the business activity. Either the renderer or the recipient of the service is engaged in the business or rendering similar services to one or more unrelated parties.

The regulations provide the example of a printing company that is regularly engaged in printing and mailing advertising literature for unrelated persons. The printing company also prints advertising circulars for a related person’s products and mails them to potential customers of its affiliates, and performs related art work. The services rendered were viewed as an integral part of the printing company’s business activity because similar services were rendered for unrelated persons.

**Service Is Not a Principal Activity of Renderer**

Services are an integral part of the business activity of a member when the renderer renders services to one or more related parties as one of its principal activities. The regulations generally presume that a renderer does not render services to related par-

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36 Treas. Reg. § 1.482-2(b)(3).
37 Treas. Reg. §§ 1.482-2(b)(7) and 1.482-2(b)(3).
38 Treas. Reg. § 1.482-2(b)(7)(i).
40 See e.g., Kenco Rests., Inc. v. Comm’r, 206 F.3d 588 (6th Cir. 2000).
ties as one of its principal activities if the cost of the services of the renderer attributable to the services for the year to related parties does not exceed 25 percent of the total cost or deductions of the renderer for the year.\footnote{41}{Treas. Reg. § 1.482-2(b)(7)(ii)(A).}

This 25 percent presumption does not apply when the service constitutes a manufacturing, production, extraction, or construction activity. If the cost of services rendered to related parties exceeds the 25 percent threshold, or if the 25 percent threshold does not apply, the determination of whether the rendering of such services is one of the principal activities is based on the facts and circumstances of each case. Facts and circumstances include the time devoted to the services, the relative cost of the services, the regularity with which the services are rendered, the amount of capital investment, the risk of loss involved, and whether the services are in the nature of supporting services or independent of other activities of the renderer.\footnote{42}{Id.}

In applying this test, all costs of services rendered to related parties are taken into account, even those of a manufacturing, production, extraction, or construction activity. Amounts properly reflected in the cost of goods sold are excluded. The safe harbor test may not apply if the cost of services rendered to related parties is not arm’s length.\footnote{43}{Treas. Reg. § 1.482-2(b)(7)(ii)(B).}

The taxpayer can choose to apply the test on a “consolidated group” basis. A consolidated group includes all members of the group organized within a single country and subject to income tax on the basis of their combined income.\footnote{44}{Treas. Reg. § 1.482-2(b)(7)(ii)(C).} This latter consolidated group rule can cause many services to come within the 25 percent safe harbor that would not otherwise have done so. The costs and expenses taken into account for this purpose are discussed in a following section.

The regulations give several examples of the mechanical operation of the safe harbor test.\footnote{45}{Treas. Reg. § 1.482-2(b)(7)(ii)(C).} In one example, the 25 percent safe harbor is not met, and wrecking services are deemed to be an integral part of the business activity of the renderer. Here there is a high risk of loss involved in rendering the wrecking services to related parties, the renderer had a large investment in the wrecking equipment, and a substantial amount of time was spent rendering wrecking services to related parties.\footnote{46}{Id., Example 3.} In another example, the 25 percent safe harbor does not apply because of a manufacturing activity; however, the affiliate provides manufacturing services in an insubstantial amount, without regularity, and for a one-month period while a related company’s machinery is broken down. The regulation holds that under such circumstances rendering the manufacturing services is not a principal activity of the renderer.\footnote{47}{Id., Example 7.}

Another example describes an affiliate providing engineering services to a related person to discover and correct defects in a manufacturing process. The 25 percent safe harbor applied because the services rendered were of a supporting nature and
did not constitute a manufacturing activity. In another example, a foreign subsidiary decides to construct a plant. Its parent draws up architectural plans, arranges financing, negotiates with governmental authorities, invites bids, and negotiates contracts to carry on the construction. The 25 percent safe harbor does not apply, even though the parent’s activities do not constitute a construction activity, because the aggregate services performed by the parent are so substantial.

**Renderer Is Not Peculiarly Capable of Rendering Service**

Services are an integral part of the business activity of a member of the group when (1) the renderer is peculiarly capable of rendering the services, and (2) such services are a principal element in the operations of the recipient. The renderer is “peculiarly capable” of rendering the services when, in connection with rendering the services, it uses a “particularly advantageous situation of circumstances,” such as by “utilization of special skills and reputation, utilization of an influential relationship with customers, or utilization of its intangible property.” The renderer is not considered peculiarly capable of rendering services unless the value of the services is substantially in excess of the costs or deductions of the renderer attributable to services.

It can often be difficult to be certain whether this test is met because it involves various subjective elements. It can be unclear whether the renderer should properly be viewed as “peculiarly capable” or whether the services are a “principal element” in the operations of the recipient. The regulations give five examples of the operation of the rule.

An example illustrates an “influential relationship” with customers, causing the renderer to be peculiarly capable of rendering the services. Here X is an automobile finance company and Y is a related life insurance agent. X requires its borrowers to have life insurance. The customers can take out life insurance from Y, but are not required to do so. Using another insurance agent would cause a delay in the processing of the loan and, as a result, almost all of X’s borrowers take out life insurance through Y. X is thus viewed as being peculiarly capable of rendering selling services to Y. Because a substantial amount of Y’s business is derived from X’s borrowers, X’s selling services are viewed as a principal element in the operation of Y’s insurance business. In addition, the value of the services is substantially in excess of the costs incurred by X. Thus, the selling services rendered by X to Y are viewed as an integral part of the business activity. In this example, the “principal element” of the operations of the recipient test is applied in a monetary sense; however, no guidance is given as to what constitutes a “substantial amount” of Y’s business.

In another example, X owns an exclusive patented process by which it detects and removes imperfections in the product of Y, a related person, thereby greatly

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48 Id., Example 8.
49 Id., Example 9.
50 Treas. Reg. § 1.482-2(b)(7)(iii).
52 Id., Example 10.
increasing the marketability of the product. Y apparently inspects all of such products. Although the activity is not a principal activity of X, the inspector, it is peculiarly capable of rendering the services because it owns the patented process. Furthermore, inspection greatly increases the marketability of the product. Inspection is extremely valuable, and the value is substantially in excess of the cost of rendering the inspection service. Because of the impact of the inspection on sales, the services are a principal element of the operations of Y. Thus the inspection services rendered by X to Y are viewed as integral parts of the business activity. This example is again replete with conclusions that give no real guidance as to the meaning of the terms; however, subsequent examples indicate that where Y (the manufacturer) also owns, or owns jointly, the patent, X (the renderer) is no longer peculiarly capable of rendering the services, and the integral business activity test is not met.

In a final example, X, a manufacturing company, has an accounting department that maintains financial records of Y, a related distributor of X’s products. Although X is able to render the accounting services more efficiently than others because of its familiarity with the operations of Y, X is not peculiarly capable of rendering the accounting services. Such familiarity does not constitute a particularly advantageous circumstance. Furthermore, the services are viewed as supporting in nature and do not constitute a principal element in the operations of Y. Thus the integral business activity test is not met.

In FSA 200230001, the IRS stated its view of “peculiarly capable” by explaining that the renderer of services need not have unique attributes. In the FSA, an experienced project finance developer was found to be “peculiarly capable” because of its special relationship with a construction affiliate and its reputation in the industry. Under the FSA, a taxpayer does not have to be uniquely qualified to perform services to qualify as peculiarly capable.

Recipient Has Not Received Benefit of Substantial Amount of Services

Services are an integral part of the business activity of a member of a controlled group when the recipient has received the benefit of a substantial amount of services from one or more related persons during the year. Services are considered substantial if the total cost or deductions of the related party or parties rendering services to the recipient during the year which are directly or indirectly related to the services, exceed 25 percent of the total costs or deductions for the recipient for the year. The recipient’s total cost includes the renderer’s costs related to rendering the services and

53 Id., Example 11.
54 Id., Examples 12 and 13.
55 Id., Example 14.
56 FSA 200230001 (March 25, 2002).
57 As recently as January 2003, Treasury and the IRS have expressed concerns regarding the particularly subjective analysis required by the “peculiarly capable” test. Kevin A. Bell, Treasury Official Previews Intercompany Services Regulations, 2003 TNT 19-7 (Jan. 28, 2003).
excludes amounts paid to the renderers for such services. Amounts paid for materials properly reflected in the cost of goods sold to the recipient are also excluded.\textsuperscript{58} The costs or deductions taken into account for this purpose are discussed next.

The regulations give two examples of the operation of this rule.\textsuperscript{59}

**Costs Taken into Account**

“Costs and deductions” incurred with respect to a service are deemed to be the IRC Section 482 arm’s-length amount if one of the integral business activity tests discussed previously is not met. The regulations set forth rules on determining “costs or deductions.”\textsuperscript{60} In addition, as discussed in previous sections two separate 25 percent tests involving a determination of “costs and deductions” apply for purposes of two of the integral business activity tests. These same regulations apply in determining what “costs or deductions” are for this purpose as well.

The “costs or deductions” regulations require taking into account on some reasonable basis all costs or deductions that are directly or indirectly related to the service performed. Direct costs or deductions are those identified specifically with a particular service, including compensation, bonuses, travel expenses, materials and supplies, and so forth. Indirect costs or deductions taken into account are those that are not specifically identified with a particular activity but that relate to direct costs. These include utilities, occupancy, supervisory and clerical compensation, and other overhead burdens of the department incurring direct costs or deductions. Indirect costs also include an appropriate share of costs or deductions relating to supporting departments and other general and administrative expenses to the extent reasonably allocable to a particular service.\textsuperscript{61}

The regulations also specify certain costs and deductions that are not to be taken into account. These include interest expense on indebtedness not incurred specifically for the benefit of another member of the group, expenses associated with the issuance of stock and maintenance of shareholder relations, and expenses of compliance with regulations or policies imposed by its government upon the member rendering the services not directly related to the service in question.\textsuperscript{62}

**InverWorld**

In *InverWorld, Inc. v. Commissioner*, the Tax Court addressed the issue of whether a foreign corporation’s allocation of income to its U.S. subsidiary was an appropriate arm’s-length charge. The foreign parent, a financial services corporation, which relied on its domestic subsidiary to provide virtually all of its investment management services to clients, allocated a cost-plus profit amount, which it claimed was comparable to the charges it had previously incurred for similar services rendered by

\textsuperscript{58} Treas. Reg. § 1.482-2(b)(7)(iv). In some cases, costs over a three-year period can be used.

\textsuperscript{59} Treas. Reg. § 1.482-2(b)(7)(v), Examples 15 and 16.

\textsuperscript{60} Treas. Reg. § 1.482-2(b)(4).

\textsuperscript{61} Id.

\textsuperscript{62} Treas. Reg. § 1.482-2(b)(5).
an independent service provider. The IRS, having determined that the domestic subsidiary effectively provided all of the services rendered by the parent to its clients, argued that the appropriate arm’s-length charge for services rendered by the subsidiary to its foreign parent was the net amount of revenues the parent derived from servicing its clients.

Although the petitioner had not relied on the safe harbor use of cost as a measure of the arm’s-length charge, the court went through a painstaking, but instructive, analysis of the reasons why the safe harbor did not apply. The court concluded that the subsidiary’s services were an integral part of its business because the subsidiary rendered services to its parent as one of its principal activities under the facts-and-circumstances 25 percent test.63

The court, lacking information on the relative cost of the services rendered by the subsidiary to its parent, extrapolated its conclusion from the percentage of revenues earned by the subsidiary from its parent over its total revenues to conclude that the 25 percent threshold had been exceeded.

Finding that the services rendered were an integral part of the business activity of the subsidiary, the court set about calculating the appropriate arm’s-length charge. The court arrived at a formula based upon the formula used by the parent company to calculate its service charges to clients, namely, the net value of the clients’ assets multiplied by variable profit percentage factors, depending on the category of investment. The court rejected the petitioner’s argument that a proper arm’s-length charge was equivalent to the prior charges of an independent service provider because, among other reasons, the other charges were not contemporaneously incurred.

Because the foreign parent had never filed a U.S. income tax return by the time of the IRS’s allocation adjustment, the court held that it was not entitled to rely on Section 482 for a correlative adjustment increasing its deductions by the amount reallocated to its domestic subsidiary. The practical consequence of the court’s finding was to create a double taxation situation.

Although InverWorld does not blaze any new ground in the Section 482 analysis of services, it is instructive from the standpoint of interpreting the rules under Treasury Regulation Section 1.482-2(b)(7) for determining arm’s-length price. The case also illustrates the increased risk a reallocation may have on the tax liability of a foreign affiliate that does not file a U.S. income tax return.64

**FAIR MARKET VALUE OF SERVICES**

If a service is an integral part of the business activity of a member of a group, or if the taxpayer chooses not to have costs or deductions deemed to be equal to an arm’s-length charge, then the relevant IRC Section 482 standard is the arm’s-length standard.65 An arm’s-length charge for services rendered is the amount that was charged

63 71 T.C.M. 3231; T.C. memo 1996, 301. Motion for reconsideration denied, 73 T.C.M. 2777; T.C. Memo 1997-226.
64 Treas. Reg. § 1.482-2(b)(7)(i).
65 Treas. Reg. § 1.482-2(b)(1).
or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances concerning all relevant facts.\textsuperscript{66} Section 482 of the IRS’s regulations give no further guidance on what an arm’s-length charge for services is in this context. Thus the taxpayer is left to the more general Section 482 regulations and the case law.

The comparability analysis that must be undertaken in other transfer pricing situations is similar to that required for services. This entails attempting to find comparable independent transactions, determining the extent to which the services are the same or similar, determining the extent to which the surrounding circumstances are the same or similar, adjusting for differences, and considering all other relevant facts. Although the regulations do not specifically permit the use of the comparable profits method (or other methodology) in determining the fair market value (or arm’s-length price) of services, economists often use the comparable profits method to make this determination. Such an approach is not consistent with the regulations.\textsuperscript{67}

The regulations give general guidance on comparability that applies to transfer pricing for services.

**Five Factors**

The regulations provide that the arm’s-length character of a controlled transaction is tested by comparing the results of the transaction with the results of uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. The regulations indicate that the comparability of transactions and circumstances must be evaluated using five factors:\textsuperscript{68}

1. Functions
2. Risks
3. Contractual terms
4. Economic conditions
5. Property or services

The relative importance of any one of these factors may vary, but the analysis of functions and risks factors is stated to be essential.\textsuperscript{69}

\textsuperscript{66} Treas. Reg. § 1.482-2(b)(3).

\textsuperscript{67} See Treas. Reg. § 1.482-1(b)(1) (“Evaluation of whether a controlled transaction produces an arm’s length result is made pursuant to a method selected under the best rule.”); Treas. Reg. § 1.482-1(c)(1) (“The arm’s length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.”). See also Kevin A. Bell, *Treasury Official Previews Intercompany Services Regs*, 2003 TNT 19-7 (Jan. 28, 2003) (Reporting that an IRS official explained that “because there are no specified methods for services, it appears that the [reasonable cause and good faith defenses to the section 6662(e)(1)(B) substantial valuation misstatement penalty] would be available if the taxpayer ‘selected and applied an unspecified method in a reasonable manner.’ ”).

\textsuperscript{68} Treas. Reg. § 1.482-1(d)(1).

\textsuperscript{69} Id.
For two transactions to be considered comparable, an uncontrolled transaction need not be identical or exactly comparable, but must be sufficiently similar so that it provides a reasonable and reliable benchmark.\(^{70}\) If necessary, a reasonable number of adjustments may be made to the results of an uncontrolled transaction to account for material differences between the controlled and uncontrolled transactions, if such differences have a definite and reasonably ascertainable effect on prices. Such adjustments should be based on commercial practices, economic principles, or statistical analyses.\(^{71}\)

In applying the aforementioned five factors, specific guidance is given by the regulations. In the case of the analysis of functions, the regulations state that it is necessary to identify and compare economically significant activities by taxpayers in controlled and uncontrolled transactions. Specific types of functions are listed.\(^{72}\)

**Comparison of Risks**

A comparison of risks requires a determination of which taxpayer bears the risks according to the contractual terms between the parties. The contractual allocation of risks will be respected provided it is consistent with the economic substance of the underlying transaction; however, an allocation of risks between controlled taxpayers after the outcome of such risks is known, or reasonably knowable, is deemed to lack economic substance.\(^{73}\) Relevant risks to consider include market risks, including fluctuations in cost, demand, pricing, and inventory levels; risks associated with the success or failure of research and development activities; financial risks, including fluctuations in foreign currency rates of exchange and interest rates; credit and collection risks; product liability risks; and general business risks related to the ownership of property, plant, and equipment.\(^{74}\) In this regard, the regulations look at whether the pattern of the controlled taxpayer’s conduct is consistent with the purported allocation of risk or whether the relevant contractual terms are modified to reflect any inconsistent conduct, whether the controlled taxpayer has the financial capacity to fund the risk, and the extent to which the controlled taxpayer exercises control over the activities influencing income or loss.\(^{75}\)

**Contract Terms and Economic Conditions**

In applying the contractual terms factor, the regulations require the comparison of significant contractual terms that could affect the prices that would be charged. This can include the form of consideration, payment terms or related financing arrangements, the volume of products, warranties, rights to updates, duration, termination or renegotiation rights, and collateral transactions.\(^{76}\) The contractual terms of the

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\(^{70}\) Treas. Reg. § 1.482-1(d)(2).

\(^{71}\) Id.

\(^{72}\) Treas. Reg. § 1.482-1(d)(3)(i).


\(^{75}\) Treas. Reg. § 1.482-1(c)(3)(iii)(B)(1–3).

parties will be respected provided such terms are consistent with the economic substance of the underlying transaction. Factors given the greatest weight in determining economic substance are the actual conduct and the respective legal rights of the parties.\textsuperscript{77} The regulations give two examples of the operation of this rule.\textsuperscript{78} In the absence of a written agreement between the parties, a contractual agreement may be imputed to reflect the economic substance of the transaction.\textsuperscript{79}

The economic conditions factor requires a comparison of significant economic factors that could affect the price, including realistic alternatives, similarity of geographic markets, relative size and extent of economic development in each market, the level of the market, relevant market shares, location-specific costs, other factors of production and distribution, and the extent of competition in each market.\textsuperscript{80}

The regulations’ property or service factor, in this context, requires a determination of whether the services transferred in controlled and uncontrolled transactions are comparable.\textsuperscript{81}

A variety of other special rules are provided by the regulations.\textsuperscript{82} For example, the IRS can consider the combined effect of two or more separate service transactions when the transactions, taken as a whole, are so interrelated that consideration of multiple transactions is necessary to determine arm’s-length consideration for the controlled transactions.\textsuperscript{83} An analysis of all the generalized Section 482 regulations is appropriate for services, as with other transactions.

**Comparability Analysis**

A transfer pricing analysis must take into account all of the factors indicated previously. It is often not possible to find comparable independent transactions, especially when virtually all of a taxpayer’s services are rendered to related parties, or when the services rendered to unrelated parties are quite different from those rendered to related persons. Thus it may be necessary to look at service transactions between two totally unrelated persons, not including the taxpayer. If the services of the taxpayer are highly specialized, such other third-party services may be significantly different but may involve the best available information. This necessitates a detailed analysis of the differences between the types of services, but because this is not often practical, the comparable profits method often is used by economists.

The court cases that have analyzed services have often analyzed the differences between transactions at some length. Nonservice cases that have involved extensive comparison of transactions and adjustments to prices are also relevant to service cases, at least in terms of the intellectual exercise that must be engaged in.

\textsuperscript{77} Treas. Reg. § 1.482-1(d)(3)(ii)(B).
\textsuperscript{78} Treas. Reg. § 1.482-1(d)(3)(ii)(C), Examples 1 and 2.
\textsuperscript{80} Treas. Reg. § 1.482-1(d)(3)(iv).
\textsuperscript{81} Treas. Reg. § 1.482-1(d)(3)(v).
\textsuperscript{82} See, generally, Treas. Reg. § 1.482-1.
\textsuperscript{83} Treas. Reg. § 1.482-1(f)(2)(i)(A).
U.S. Steel

In *United States Steel Corporation v. Commissioner*, the Second Circuit Court of Appeals engaged in some analysis of the differences in the transactions (shipping services) between U.S. Steel’s foreign shipping subsidiary (“Navios”) and U.S. Steel, and between Navios and unrelated companies. For example, the volume of ore shipments by Navios to U.S. Steel in the relevant years was 10 or 20 times the volume of shipments to unrelated persons. Despite the volume difference and certain other differences, the court stated that, under the regulations, if the taxpayer can show that the amount it paid was equal to the amount charged for the same or similar services in independent transactions, the taxpayer can defeat the application of Section 482. The court viewed Navios’s other transactions as independent. It indicated that there need not be a perfectly competitive market. The court found that, because there were independent transactions significant in number and dollar amount over a long period, the difference in volume did not matter. The court believed that there were very few transactions in which industries or transactions were truly comparable in a strict sense. Applying a relatively liberal standard of comparability, the court upheld the taxpayer’s pricing.

It should be noted that the services of the type dealt with in *U.S. Steel* involved substantial investments in property (ships), a factor that was not emphasized by the court. An analysis of the differences in the circumstances of sewing services between related and unrelated transactions can be found in the relatively old case of *Ross Glove Co. v. Commissioner*.

Westreco

Perhaps the best analysis of comparability in the services context is found in *Westreco Inc. v. Commissioner*, which involved research services performed by a U.S. company for a foreign affiliate. The Tax Court engaged in an intensive analysis of comparable companies. The taxpayer’s expert chose four corporations with somewhat similar, but by no means identical, engineering/research businesses. His comparison looked at business relations with clients, financial comparability, and economic and business risks (e.g., client risk, general business risk, research risk, and downstream market risk).

For example, some of the four were pure contract research firms, such as Westreco, in which the client identifies the project and pays for the results, whether commercially successful or not. The other two companies developed technology for their own accounts. Some of the companies were smaller, and others were larger, with different ratios of fixed assets to total assets, but all had similar ratios of sales to both total and operating assets. The other corporations had more day-to-day risk.

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84 1617 F.2d 942 (2d Cir. 1980).
85 Id., at 949–951.
86 60 T.C. 569 (1973).
87 64 T.C.M. 849 (1992).
than Westreco because Westreco did not have to regularly solicit new clients. All of
Westreco’s services were performed for one related company. All of the corporations,
including Westreco, faced client risks if the quality of work fell below certain stan-
dards or if costs became excessive. The other corporations faced higher general busi-
ness risk because Westreco was contractually committed to be compensated for all
of its expenses except taxes. In other risk areas, such as the downstream market risk
area, the companies were quite comparable.

The expert then evaluated Westreco and the comparable corporations using four
ratios: (1) operating income as a percentage of net sales; (2) operating income as a
percentage of operating assets; (3) pretax income as a percentage of net sales; and (4)
pretax income as a percentage of total assets. The expert concluded that Westreco’s
profits should have been similar to, but somewhat lower than, the other four com-
panies, because two of them developed commercially viable technology for their
own accounts, and because Westreco’s profits were more consistent because it faced
lower risks. The other corporations were expected to realize higher average profits
to compensate for the higher risks.

The IRS also presented expert witnesses that selected 15 “comparable” corpo-
rations from the same Standard Industrial Classification (SIC) code. The selected
companies included an even wider variety of differences than the four selected by
Westreco. The court spent much time explaining why it believed that companies
selected by the IRS were quite different and had not been sufficiently compared with
Westreco.

Ultimately, the court rejected the IRS’s arguments and accepted the taxpayer’s
transfer price for services in its entirety. Perhaps the most important lesson to be
learned from Westreco is that careful analysis in comparing related-party transac-
tions with unrelated transactions can be quite successful.

Arm’s-Length Price

Numerous methodologies have been adopted from the regulations and case law
applicable to the transfer pricing of services:

- In HCA and Nat Harrison, the courts adopted 75/25 or 25/75 profit splits,
  based on their judgments as to what the appropriate pricing should be. Little
  analysis was given by the courts as to how they arrived at the profit splits.
- In U.S. Steel, the taxpayer’s price was upheld, which was the same for related
  and unrelated transactions, even though there were differences in circumstances.
- In Diefenthal, the court upheld the use of prices obtained by the taxpayer in
  open market transactions and decided that the differences in circumstances were
  not sufficient to justify a difference in price.
- In Ross Glove, the court looked at several different circumstances and came up
  with a different price.
- In Ciba-Geigy, the court did not uphold an allocation where the taxpayer was
  able to show that in unrelated transaction charges were not made, but upheld the
  application of Section 482 when it could not make the same showing. In that
case, the court imposed its own judgment, without analysis, as to the proper charge for the services.

In Westreco, the court upheld a taxpayer’s cost-plus formula. Extensive analysis concluded that the rate of return derived by the taxpayer was within what an appropriate rate of return should be under the circumstances, even though all of the taxpayer’s transactions were with an affiliate. In Westreco, the use of somewhat similar services and rates of return by unrelated persons in somewhat similar circumstances was persuasive to the court, when the differences were explained.

In these cases, the taxpayer was far more successful when it could show at least relatively comparable third-party transactions or, in the case of Westreco, when it was able to do an extensive analysis of why it should derive a rate of return similar to that of other companies. The Westreco type of analysis is often likely to be needed when the taxpayer enters into all, or virtually all, of its service transactions with related persons. A careful analysis of rate of return statistics of third parties engaging in the most similar services available, including adjusting for as many differences as possible, is desirable.

**Foreign Subsidiaries**

In many cases, companies form foreign subsidiaries in another jurisdiction for reasons substantially or totally unrelated to taxation. They might easily have operated in the other country in branch form rather than subsidiary form. The subsidiary may not have significant assets or risks. In such cases, it may be that the salary and benefits paid to the subsidiary’s employees, plus other expenses incurred by the subsidiary, is the best measure of an arm’s-length price. If a branch had been utilized, the only cost would have been the employee and other expenses. An unrelated person, under similar circumstances, would in many cases require only a small markup, especially when no significant risks are involved. If, however, the company also owns other property that is used in the business (e.g., a building), the rate of return to which the corporation should be entitled might appropriately include a return for the use of the property as well. The more complex the business of the company, the more difficult the transfer pricing analysis will be. Where a subsidiary is in a service business, but valuable intangible property is also involved, there may be significant difficulties in differentiating between the intangibles and the services, resulting in increasing complexity and difficulty in determining the appropriate transfer price.

Nevertheless, the cases support the proposition that a careful and reasoned analysis of differences in transactions or companies is key. If the various factors set forth by the IRS in its general Section 482 regulations are analyzed carefully by qualified economists or other pricing specialists in setting transfer prices for services, the taxpayer can be put in the best possible position (absent an advance pricing agreement with the IRS) for sustaining its transfer pricing and avoiding the imposition of penalties.
FUTURE DEVELOPMENTS

The transfer pricing rules relating to the treatment of services are among the last requiring completion by the IRS.88 The current safe harbor regulations allow the permissive use of cost as an arm's-length price, provided that the taxpayer can demonstrate that the services rendered are not an integral part of the business activity of a member of the group of controlled entities. The OECD Transfer Pricing Guidelines for MNEs urges the IRS not to adopt safe harbors in its final regulations relating to services, claiming that safe harbors are not compatible with transfer pricing enforcement provisions.89 However, while a Treasury Official recently stated Treasury’s intention to keep a safe harbor rule,90 it is expected that changes will be made to the safe harbor. In addition, Treasury and the IRS are also hoping to clarify whether a transaction qualifies as the performance of services or the transfer of intangibles, believing that this is a “very gray area” that depends on the facts and circumstances of each case.91

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88 See supra note 3.
89 OECD Transfer Pricing Guidelines for MNEs ¶ 7.37
CONCEPTUAL OVERVIEW

Cost sharing allows parties to agree to pool resources to develop one or more intangibles and to share the benefits of such developed intangibles. Unrelated parties clearly would establish estimates of the benefits they would expect from a successful collaboration in relation to their share of the costs being assumed, even if their estimates differed or other strategic business reasons influenced the cost-sharing agreement.

BACKGROUND

Traditional intangible transfer analysis generally relies on the notion that a single party expends funds to develop an intangible and then becomes a licensor of the developed intangible to others in exchange for royalties. This traditional analysis has specific implications for multinational groups, both U.S.-based as well as non-U.S.-based multinationals.

For U.S.-based multinationals, a single U.S. owner–developer scenario implies foreign source royalty income, possible Subpart F or other U.S. antideferral considerations, foreign tax credit (FTC) expense apportionments, impacts on R&D credit calculations, and a variety of potential non-U.S. income tax, customs duty, and/or Value-Added Tax considerations. For non-U.S.-based multinationals, a single non-U.S. owner–developer implies U.S.-based royalties, possible U.S. withholding taxes, potential treaty-based tax return positions, possible purchase of non-U.S.-produced goods, and a variety of potential U.S. customs duty as well as state and local franchise or income tax considerations. As described in greater detail later, cost sharing creates a new paradigm that requires a different perspective for both U.S.-based and non-U.S.-based multinationals.

TREASURY’S CONCERNS

Unrelated parties might evaluate benefits in subjective terms (such as the opportunity for them to collaborate with X Corp. or to keep X Corp. from collaborating with one
of its competitors) as well as numerical estimates; however, the U.S. cost-sharing regulations focus on numerical relationships to establish, measure compliance with, and adjust contributions to cost-sharing agreements. This analysis reflects the continuing concerns of the U.S. tax authorities about related-party cost sharing.

With U.S.-based multinationals, a primary concern has been the possibility of one or more foreign affiliates gaining cheap access to a potentially large deferral ability through cherry-picking. In effect, the foreign subsidiary might gain access to an intangible’s full benefits by only contributing to the final development stages and not bearing the risks of unsuccessful research. With non-U.S.-based multinationals, a primary concern has been the possibility of the U.S. entity making significant U.S. deductible contributions to a cost-sharing agreement that has little likelihood of generating any intangibles that the U.S. party might significantly exploit. Thus the U.S. focus has generally been confined to an affinity for mathematical precision in an area defined by current risk and uncertain future reward.

HISTORICAL PERSPECTIVE

Internal Revenue Code (IRC) Section 482 grants the IRS the authority to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among commonly controlled entities when necessary to prevent evasion of tax or to clearly reflect income. Thus, under appropriate circumstances, the IRS has a clear grant of authority to adjust the amount of costs borne by a U.S. taxpayer who is a party to a cost-sharing arrangement. An interesting framework also has been constructed to address the possibility of adjustments that would only affect non-U.S. parties to a cost-sharing arrangement who are not U.S. taxpayers.

Introducing the “Commensurate with Income” Standard

The Tax Reform Act of 1986 (the Act) amended Section 482 to require that consideration for intangible property transferred in a controlled transaction be commensurate with the income attributable to the intangible. The Conference Committee report to the Act indicated that, in revising Section 482, Congress did not intend to preclude the use of bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties. The Conference Committee report stated, however, that in order for cost-sharing arrangements to produce results consistent with the commensurate-with-income standard, three specific standards apply:

1. A cost sharer should be expected to bear its portion of all research and development costs, on unsuccessful as well as successful products, within an appropr-
ate product area, and the costs of research and development at all relevant development stages should be shared.

2. The allocation of costs generally should be proportionate to profit as determined before deduction for research and development.

3. To the extent that one party contributes funds toward research and development at a significantly earlier point in time than another or is otherwise putting its funds at risk to a greater extent than the other, that party should receive an appropriate return on its investment.

The Conference Committee report to the 1986 Act recommended that the IRS conduct a comprehensive study and consider whether the 1968 regulations under Section 482 should be modified in any respect.

The White Paper

In response to the Conference Committee’s directive on October 18, 1988, the IRS and the Treasury Department issued a study of intercompany pricing (the White Paper). The White Paper suggested that most bona fide cost-sharing arrangements should have certain provisions. For example, the White Paper stated that most product areas covered by cost-sharing arrangements should be within three-digit Standard Industrial Classification (SIC) codes, that most participants should be assigned exclusive geographic rights in developed intangibles, should predict benefits and divide costs accordingly, and that marketing intangibles should be excluded from bona fide cost-sharing arrangements.

As subsequently noted by the Treasury, comments on the White Paper indicated that, in practice, there was a great deal of variety in the terms of bona fide cost-sharing arrangements, and that if the White Paper’s suggestions were incorporated into regulations, the regulations would unduly restrict the availability of cost sharing.

1992 Proposed Regulations

On January 30, 1992, the IRS issued proposed cost-sharing regulations under the 1986 Act that would revise the 1968 regulations. According to the IRS, these 1992 proposed cost-sharing regulations provided more flexibility than anticipated by the White Paper by relying on antiabuse tests rather than requiring standard cost-sharing provisions. The 1992 proposed regulations stated that in order to be qualified, a cost-sharing arrangement had to meet five fundamental requirements:

1. The cost-sharing arrangement had to have two or more eligible participants.
2. The cost-sharing arrangement had to be recorded in writing contemporaneously with the formation of the cost-sharing arrangement.

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6 T.D. 8632, 12/19/95.
7 Id.
8 Id.
3. The eligible participants to the cost-sharing arrangement had to share the costs and risks of intangible development in return for a specified interest in any intangible produced.
4. The cost-sharing arrangement had to reflect a reasonable effort by each eligible participant to share costs and risks in proportion to anticipated benefits from using developed intangibles.
5. The cost-sharing arrangement had to meet certain administrative requirements.

Each of these fundamental requirements is reflected in the final regulations in varying degrees. Taxpayers and practitioners alike had several areas of significant concern that they felt might create sufficient taxpayer uncertainty as to actively discourage the use of cost-sharing arrangements. The concerns included:

- Using mechanically calculated cost-to-operating income ratios to test the reasonableness of sharing costs in proportion to anticipated benefits
- Restricting the definition of an eligible participant effectively to a manufacturing entity
- Requiring every participant to benefit from every intangible developed under the cost-sharing arrangement
- Requiring compliance with complex buy-in and buyout rules without safe harbor provisions
- Generating what were criticized as burdensome administrative rules

These and other issues raised about the 1992 proposed regulations were considered by the IRS in the development of the final regulations.  

**SCOPE, APPLICATION, AND LIMITATIONS OF THE FINAL REGULATIONS**

Under the Final Regulations, a taxpayer who is a “controlled participant” in a “qualified cost-sharing arrangement” may acquire ownership of an intangible for U.S. tax purposes. The general rules of U.S. taxation apply where an arrangement is not a qualified cost-sharing arrangement, as well as where a controlled taxpayer that is not a controlled participant provides assistance to a qualified cost-sharing arrangement.

**Scope and Application**

A cost-sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the agreement. A taxpayer may rely on the

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9 *Id.*

10 Treas. Reg. § 1.482-7(a)(1).
U.S. cost-sharing rules only if the arrangement meets the definitional requirements of a “qualified cost-sharing arrangement” and the taxpayer is a “controlled participant” in that qualified cost-sharing arrangement.

Consistent with the traditional notion that Section 482 has been the IRS’s sword but not the taxpayer’s shield, the District Director may apply the cost-sharing rules to any arrangement that in substance constitutes a qualified cost-sharing arrangement, notwithstanding a failure to comply with any requirement of the regulations.11 This fact raises interesting issues in the context of marketing intangibles. For example, the author of the Final Regulations commented that the regulations could apply in the context of marketing intangibles. Nevertheless, the IRS subsequently stepped up its examination efforts in the context of advertising and marketing expenditures involving U.S. subsidiaries of non-U.S. parents without explicitly suggesting that a deemed qualified cost-sharing arrangement might exist.

**Limitations on Application**

The Final Regulations provide two safe harbors in response to requests from taxpayers and practitioners. First, an actual or deemed qualified cost-sharing arrangement will not be treated as a partnership to which the rules of Subchapter K apply.12 Second, a participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in a U.S. trade or business solely by reason of its participation in a qualified cost-sharing arrangement.13 Taken together, these two provisions provide substantial authority safeguards to foreign corporations previously concerned about becoming subject to U.S. taxation solely through participation in cost-sharing arrangements.

**Limitation on Allocations**

The IRS generally will not make allocations as to a qualified cost-sharing arrangement, except to the extent necessary to make each controlled participant’s share of the costs of intangible development equal to its share of reasonably anticipated benefits.14 This provision has two principal benefits. This limitation favorably responds to taxpayers’ concerns about certain possibilities of deemed intangible transfers expressed after the White Paper and 1992 Proposed Regulations were issued. In addition, the limitation reduces, if not eliminates, the ability of the IRS to make adjustments to the results of qualified cost-sharing arrangements under such other Section 482 methodologies as CUP, resale price, or profit split, as long as the taxpayer is a controlled participant of that qualified cost-sharing arrangement.

The IRS may apply the normal Section 482 rules governing transfers of intangibles where a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer outside the scope of a qualified cost-sharing arrange-

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11 Id.
12 Id.
13 Id., and see Treas. Reg. § 301.7701-3(e).
14 Treas. Reg. § 1.482-7(a)(2).
The cost-sharing rules define an interest in an intangible as any commercially transferable interest, the benefits of which are capable of valuation.16

**QUALIFIED COST-SHARING ARRANGEMENT DEFINED**

A qualified cost-sharing arrangement must:

- Include two or more participants
- Provide a method to calculate each controlled participant’s share of intangible development costs, based on factors that can reasonably be expected to reflect that participant’s share of anticipated benefits
- Provide for adjustment to the controlled participants’ shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement
- Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost-sharing arrangement

The cost-sharing arrangement document must include:17

- A list of the arrangement’s participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost-sharing arrangement
- The information methodology and adjustments described previously
- A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed
- A description of each participant’s interest in any covered intangibles (a covered intangible is any intangible property that is developed as a result of the research and development undertaken under the cost-sharing arrangement)
- The duration of the arrangement
- The conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangible

The requirement to develop and document a methodology for establishing and potentially subsequently adjusting a controlled participant’s share of intangible development costs retains the government’s “commensurate with income” and “periodic adjustment” themes consistent with the evolution of its views on transfer pricing generally; however, the ability to define the scope of the arrangement to either a single intangible or a class of intangibles represents a more practical approach to

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16 Treas. Reg. § 1.482-7(a)(2).
17 Treas. Reg. § 1.482-7(b).
business operations than the seemingly overly broad three-digit SIC code scope espoused in the White Paper.

**CONTROLLED AND UNCONTROLLED PARTICIPANTS DISTINGUISHED**

The Final Regulations divide all controlled taxpayers\(^\text{18}\) into two groups: controlled participants and uncontrolled participants. Only controlled participants can be valid members of a qualified cost-sharing arrangement.

### Controlled Participants Generally

A controlled taxpayer may be a controlled participant in a qualified cost-sharing arrangement only if it meets three conditions:\(^\text{19}\)

1. The benefits test
2. The accounting requirements
3. The administrative requirements

All members of a consolidated tax return group are treated as a single taxpayer for purposes of the cost-sharing rules.\(^\text{20}\) On the surface, this appears to simplify the application of the cost-sharing rules, but it does raise some interesting consolidated tax return issues as members enter and leave a consolidated tax return group.

### Benefits Test

A controlled taxpayer may be a controlled participant only if it reasonably anticipates that it will derive benefits from the use of the covered intangibles.\(^\text{21}\) The issue then is how reasonable is that anticipation of benefits.

For example, consider the case of a Foreign Parent (FP) corporation engaged in extracting a natural resource. FP sells supplies of this resource to its U.S. subsidiary (USS) for resale in the United States because this resource does not exist in the United States. Assume that FP and USS enter into a cost-sharing arrangement to develop a new machine to extract that natural resource, the machine uses a new extraction process that will be patented in the United States and elsewhere, and that USS will receive the rights to use the machine to extract that natural resource in the United States. Despite the rights received by USS, it cannot be a qualified participant because the lack of that natural resource existing in the United States precludes USS from deriving a benefit from the use of the intangible developed under the cost-sharing arrangement.\(^\text{22}\) In that case, consider how the district director will view USS’s

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\(^{18}\) Treas. Reg. § 1.482-1(i)(5).
\(^{19}\) Treas. Reg. § 1.482-7(c)(1).
\(^{20}\) Treas. Reg. § 1.482-7(c)(3).
\(^{21}\) Treas. Reg. § 1.482-7(c)(1)(i).
\(^{22}\) Treas. Reg. § 1.482-7(c)(1)(iv), Example 1.
payments to FP under the arrangement given the application of the U.S. tax rules outside of qualified cost-sharing arrangements.

**Accounting Requirements**

The second condition to achieve controlled participant status is that the controlled taxpayer must substantially comply with two accounting requirements. First, controlled participants in a qualified cost-sharing arrangement must use a consistent method of accounting to measure costs and benefits under the arrangement. This appears to allow taxpayers flexibility with limits.

Given the definition of “includible costs” covered later, it also appears to promote the consistent application over time of cost/benefit tests. Questions may arise in the future as to whether certain otherwise includible costs, which did not exist at the formation of the arrangement, might require the filing of a Change of Accounting Method application with the IRS. Alternatively, the broad definition of includible costs in the regulations may be sufficient given the authority of the IRS to examine and potentially adjust the allocation of costs among participants. Clarification by the IRS in this area would be helpful to taxpayers.

The second accounting requirement is that the controlled participants must translate foreign currencies on a consistent basis. This also promotes consistency over time and minimizes the long-term impact of exchange fluctuations.

**Administrative Requirements**

The administrative requirements consist of the documentation requirements and the reporting requirements. The documentation rules provide that a controlled participant should generate contemporaneously and must maintain sufficient documentation to establish that the requirements concerning documenting the agreement and validating the qualified participants have been met, as well as the additional documentation specified as follows. The controlled participant must provide any such documentation to the IRS within 30 days of a request unless an extension is granted by the District Director. Documents necessary to establish the following items must be maintained:

- The total amount of costs incurred pursuant to the arrangement
- The costs borne by each controlled participant
- A description of the method used to determine each controlled participant’s share of the intangible development costs, including the projections used to estimate benefits, and an explanation of why that method was selected
- The accounting method used to determine the costs and benefits of the intangible development, including the method used to translate foreign currencies, and,

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23 Treas. Reg. § 1.482-7(c)(1)(ii).
24 Treas. Reg. § 1.482-7(i).
25 Id.
26 Treas. Reg. § 1.482-7(j)(1).
27 Treas. Reg. § 1.482-7(j)(2)(i).
to the extent that the method materially differs from U.S. Generally Accepted Accounting Principles, an explanation of such material differences

Prior research, if any, undertaken in the intangible development area, any tangible or intangible property made available for use in the arrangement, by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles

By contemporaneously establishing this documentation, the controlled participant will satisfy the principal documents requirement of the transfer pricing penalty regulations concerning a qualified cost-sharing arrangement.28

The reporting requirements provide that a controlled participant must annually attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost-sharing arrangement and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached annually to Schedule M of any Form 5471 or to any Form 5472 filed as to that participant.29 Furthermore, the Chief Counsel’s Office has warned that failure to meet the annual reporting requirement will preclude the taxpayer from claiming that a qualified cost-sharing arrangement exists for any such nonreported year beginning on or after January 1, 1996.30

Subgroups

Cost-sharing subgroups are now possible. One member of a group of controlled taxpayers can participate on behalf of one or more other members of the group (a cost-sharing subgroup). The participating subgroup member can then transfer or license the intangibles developed under the arrangement to the nonparticipating subgroup member(s).

This procedure is consistent with the thrust of the 1992 proposed regulations.31 The proposed regulations would have required intangibles developed under the arrangement to be used in the active conduct of the “eligible participant’s” trade or business.32 For this purpose, a participant actively conducted a trade or business only if it carried out substantial managerial and operational activities.33 Mere licensing of an intangible developed under a cost-sharing arrangement would not normally qualify under the active conduct test; however, the 1992 proposed regulations would have allowed cost-sharing subgroups to meet the active conduct test by treating the subgroup as a single participant in the arrangement.34

29 Treas. Reg. § 1.482-7(j)(3).
30 FSA 20009022.
When the Final Regulations were first published, they retained the active conduct test but excluded the subgroup rules.\(^{35}\) This had the effect of potentially invalidating existing cost-sharing subgroups and preventing new ones from being formed. This change was not well received, and Treasury revisited the issue. As a result, the Final Regulations were amended to repeal the “active conduct” rule and to replace it with the “reasonable anticipation of benefits” rule, which effectively restored cost-sharing subgroups.\(^{36}\)

Many U.S.-based multinationals have effectively used cost-sharing subgroups as a means of reducing their non-U.S. tax burdens. For example, a low foreign tax rate jurisdiction member of a subgroup, which is the controlled participant of a qualified cost-sharing arrangement, could license developed intangibles to manufacturing subgroup members in high foreign tax rate jurisdictions in exchange for royalties. Without addressing here the potential application of any of the U.S. antideferral rules, the U.S. multinational has at least achieved a tax rate arbitrage on the foreign manufacturing profits paid as royalties to the subgroup member that is the controlled participant.

### Uncontrolled Participants

Controlled taxpayers that participate in qualified cost-sharing arrangements but do not meet the requirements of being a controlled participant are deemed to be uncontrolled participants.\(^{37}\) As a result, they neither account for their costs under the cost-sharing rules nor are eligible for the developed intangible tax ownership benefits of controlled participants.

When an uncontrolled participant provides assistance to a qualified cost-sharing arrangement, the uncontrolled participant must be compensated by the controlled participants. The compensation is based on allocations as to assistance provided to the owner of an intangible.\(^{38}\) For purposes of the cost-sharing rules, that compensation is treated as an operating expense to be borne pro rata by the controlled participants according to their respective shares of reasonably anticipated benefits.\(^{39}\)

For example, assume that U.S. Parent (USP), one foreign subsidiary (FSM), and a second foreign subsidiary constituting the group’s research arm (FSR&D) enter into a cost-sharing agreement to develop manufacturing intangibles for a new product line. USP and FSM are assigned the exclusive rights to exploit the intangibles in the United States and the rest of the world, respectively, where each presently manufactures and sells various existing product lines.

FSR&D is not assigned any rights to exploit the intangibles, and its activity consists solely in carrying out research for that group. As a result, FSR&D is an uncontrolled participant because it cannot reasonably expect to derive any benefits from the use of any intangibles developed under the arrangement. Therefore, USP and

\(^{35}\) See Treas. Reg. § 1.482-7(c) in T.D. 8632, 12/19/95, prior to amendment by T.D. 8670, 5/9/96.

\(^{36}\) T.D. 8670, 5/9/96.

\(^{37}\) Treas. Reg. § 1.482-7(c)(2).


\(^{39}\) Treas. Reg. § 1.482-7(c)(2).
FSM need to compensate FSR&D at an arm’s-length markup on its costs in relation to their respective shares of costs and anticipated benefits. Likewise, FSR&D will not be considered to bear any share of the intangible development costs under the arrangement. This example views FSR&D as a contract research provider.

**COSTS**

Ultimately, in testing whether a cost-sharing allocation for a particular year is appropriate, a controlled participant’s share of “costs” must be compared to its share of “benefits.” Thus, in an environment where meaningful relationships exist between shares of costs and benefits, it is initially important to understand how the relevant “costs” are defined and calculated.

**Intangible Development Costs**

A controlled participant’s costs of developing intangibles for a taxable year is equal to the costs incurred by that participant that relate to the intangible development area, plus all of the cost-sharing payments made to other controlled and uncontrolled participants, less any payments received from controlled and uncontrolled participants. Costs incurred related to the intangible development area include operating expenses as defined and express or implied rental fees for the use of any tangible property made available to the arrangement.

Intangible development costs do not include depreciation or amortization expenses because of the requirement to have arm’s-length charges for tangible property made available to the arrangement. Likewise, intangible development costs exclude nonoperating expenses such as interest, foreign or domestic taxes, other costs that do not contribute to, and buy-in payments (i.e., charges for the use of intangibles made available to the arrangement). The two examples in the regulations provide fairly straightforward scenarios to demonstrate these includible and excludible costs.

A more challenging area involves the possibility that a particular cost may contribute to both the intangible development area as well as one or more other areas. As might be expected, the taxpayer must allocate such costs among the relevant areas on a reasonable basis; however, the regulations go on to require the taxpayer to estimate the total benefits attributable to the cost incurred as the primary basis for such allocation. That is, the share of such multidimensional costs allocated to the intangible development area must correspond to covered intangibles’ share of the total benefits.

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40 Adapted from Treas. Reg. § 1.482-7(c)(2)(ii).
41 Treas. Reg. § 1.482-7(f)(1).
42 Treas. Reg. § 1.482-7(d)(1).
43 Id., and see § 1.482-5(d)(3).
44 Treas. Reg. § 1.482-7(d)(1) and see § 1.482-2(c).
45 Treas. Reg. § 1.482-7(d)(1) and see § 1.482-7(g)(2).
46 Treas. Reg. § 1.482-7(d)(1).
This procedure radically departs from the flexible apportionment methodology used in other areas outside of the cost-sharing regulations, such as time spent. For example, suppose a taxpayer separately accounts for a centralized human resource (HR) function. The HR function may benefit each area equally as a function of time spent, but how does the taxpayer quantify the benefit? It appears that the taxpayer must at least address and document the benefits issue in this situation even if the taxpayer ultimately decides that time spent or some other measure is appropriate based on equality of perceived benefits among areas.

**Share of Intangible Development Costs**

A controlled participant’s share of intangible development costs for a taxable year equals the controlled participant’s intangible development costs divided by the sum of the intangible development costs of all controlled participants.\(^{47}\) This may appear to be a very simple allocation, but it is necessary to remove any third-party shares of the development costs before making the allocation.

For example, assume that X and Y are related and, together with unrelated Z, they enter into a cost-sharing arrangement. Total costs incurred in Year 1 are $2.25 million, including contributions from X ($1.2 million), Y ($800,000), and Z ($250,000). For purposes of testing the reasonableness of the cost allocations of the arrangement, X’s share is 60 percent and Y’s share is 40 percent. As an unrelated party, Z’s costs are excluded for this purpose. Therefore, the appropriate denominator for the calculations includes only contributions from the controlled participants X and Y (i.e., $2 million.)\(^{48}\)

**Stock-Based Compensation**

The treatment of stock options costs and the costs of other forms of stock-based compensation in determining the pool of operating costs as part of a qualified cost-sharing arrangement has generated numerous disputes between taxpayers and the IRS. The inclusion or exclusion of these costs has been a publicly known source of controversy since the IRS’s examination of Seagate Technology Inc.’s 1991 and 1992 tax returns\(^{49}\) The Seagate case eventually was settled. The IRS varied its stance between a “fact-specific” basis as in Seagate and reliance on the 1968 regulations; however, that controversy subsequently continued with two cases involving the 1995 Regulations. The first was *Adaptec Inc. v. Commissioner*,\(^{50}\) and the second was *Xilinx Inc. v. Commissioner*.\(^{51}\)

The U.S. tax authorities’ position has two simple premises:

1. Most companies involved in cost-sharing arrangements have more research and development inside the United States than outside the United States, and therefore more R&D-related costs take place inside the U.S. participant.

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\(^{47}\) Treas. Reg. § 1.482-7(f)(2)(i).

\(^{48}\) Adapted from Treas. Reg. § 1.482-7(f)(2)(ii).

\(^{49}\) Seagate Technology, Inc. v Comr., Tax Court No. 15086-98.

\(^{50}\) Adaptec Inc. v Comr., T.C. No. 3480-01.

\(^{51}\) Xilinx Inc. v. Comr., T.C. No. 4142-01.
2. More U.S.-based companies involved in cost-sharing arrangements use stock options or other stock-based compensation than non—U.S.-based companies.

If both premises are correct, then every additional dollar of cost added to the pool of operating expenses to be shared results in more of the pool assigned to the non-U.S. participant, thereby increasing the U.S. taxable income of the U.S. participant.

For example, assume that US Parent (USP) incurs all $1,000 of operating costs related to the development of a manufacturing intangible. Further assume that USP has a 60:40 qualified cost-sharing arrangement with its Foreign Subsidiary (FS), exclusive of any stock option costs. Thus, USP’s share of the $1,000 is $600, and FS’s share is $400. If exercised stock options by R&D personnel that year had a value of $50 and these costs were added to the cost-sharing expense pool, then FS would have to increase its cost-sharing payment to USP from $400 to $420. As discussed more fully in a following section, the additional $20 ultimately increases USP’s U.S. taxable income by $20.

Alternately, taxpayers and many practitioners maintain that stock-based compensation has no place in the pool of operating expenses to be shared among the participants. They argue that third-party cost-sharing agreements would not and do not include stock option exercise costs. These taxpayers and many practitioners view the exercise of options as either not a cost or as not an operating cost, even if they could be construed as a cost. They also argue that such an interpretation is inconsistent with other countries, especially the Organization for Economic Cooperation and Development (OECD) trading partners of the United States, which could lead to further disharmony and administrative disputes. Under these circumstances, in the absence of explicit authority for the U.S. Treasury’s position, most U.S. taxpayers have not included stock-based compensation in their cost-sharing arrangements.

As a result of its continuing disagreements with taxpayers, the U.S. Treasury released Proposed Regulations in July 2002. Despite significant opposition from and proposed changes by taxpayers and practitioners, the U.S. Treasury released Final Regulations in August 2003 that contained only minor changes. The 2003 Final Regulations mandate the inclusion of stock-based compensation as part of the operating expenses that are subject to the cost-sharing pool.52 Moreover, the 2003 Final Regulations go so far as to effectively provide that a qualified cost-sharing arrangement that fails to include stock-based compensation among the costs to be shared does not meet the arm’s-length standard.53 This treatment could lead to disastrous results to taxpayers that apply cost-sharing.

The definition of stock-based compensation in the 2003 Final Regulations is so broad that it goes far beyond nonqualified stock options that normally result in a tax deduction upon exercise. The 2003 Final Regulations seek to include qualified options (which give rise to no tax deduction), stock appreciation rights, and restricted stock, among others.54

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52 Regs. Section 1.482-7(d)(2)(i).
53 Regs. Section 1.482-7(a)(3).
54 Regs. Section 1.482-7(d)(2)(i).
The 2003 Final Regulations limit the stock-based compensation taken into account. The regulations seek to do so by requiring that the employee was working on research related to the qualified cost-sharing arrangement at the time she or he received the grant of the stock-based compensation (e.g., the option grant date). That employee need not be working on the qualified cost-sharing arrangement at the date of exercise. In addition, the amount treated as an operating expense for cost-sharing purposes is determined based on the actual or deemed amount and timing of the tax deduction related to the stock-based compensation. Exceptions exist for replaced options, unexercised stock-based compensation at the termination of a qualified cost-sharing arrangement, and options on U.S. publicly traded stock subject to U.S. Generally Accepted Accounting Principles (GAAP).

It will be interesting to monitor any increase in competent authority cases resulting from these regulations because many practitioners believe they exceed the cost-sharing rules of other OECD members. It will also be interesting to see how non-U.S.-based multinationals that have U.S. members of cost-sharing arrangements as well as U.S.-based research and development efforts respond to the Final Regulations.

**BENEFITS**

Where the concepts of defining and calculating relevant costs are reasonably clear, defining and calculating relevant benefits can be significantly more complex. Nevertheless, the taxpayer ultimately must calculate its share of reasonably anticipated benefits.

**Reasonably Anticipated Benefits**

Initially, for purposes of the cost-sharing rules, “benefits” are additional income generated or costs saved by the use of covered intangibles. A controlled participant’s reasonably anticipated benefits, then, are the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles.

**Share of Reasonably Anticipated Benefits**

As with costs, the taxpayer’s share of reasonably anticipated benefits equals its reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits of all the controlled participants. Again, consistent with costs, anticipated

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55 Regs. Section 1.482-7(d)(2)(ii).
56 Regs. Section 1.482-7(d)(2)(iii)(A).
59 Regs. Section 1.482-7(d)(2)(iii)(B).
60 Treas. Reg. § 1.482-7(e)(1).
61 Treas. Reg. § 1.482-7(e)(2).
benefits of uncontrolled participants are excluded from such calculations. Therefore, just as in tangible and intangible property transfers, the overall examination inquiry in a cost-sharing inquiry will focus on related-party transactions.

**Reliability of Estimate**

A controlled participant’s share of reasonably anticipated benefits is determined using the most reliable estimate of reasonably anticipated benefits. In choosing among two or more estimates, the quality of the data and assumptions employed helps determine which estimate is most reliable. Reliability of the estimate, in turn, depends on the completeness and accuracy of the data, soundness of the assumptions, and relative effects of particular deficiencies in data or assumptions on different estimates. The “most reliable estimate” concept in cost-sharing becomes analogous to the “best method” rule for transfers of tangible and intangible property.

Where two estimates are equally reliable, neither the IRS nor the taxpayer needs to make an adjustment based on differences in the results. Experience suggests that it may be easier for the taxpayer to develop different methodologies for generating estimates than to convince the IRS that any two estimates are equally reliable. Nevertheless, the reliability of the basis used to measure benefits and the reliability of the projections used to estimate benefits are deemed particularly relevant to determining the reliability of an estimate of anticipated benefits.

**MEASURING BENEFITS**

The amount of benefits that each controlled participant is reasonably anticipated to derive from covered intangibles must be measured consistently for all such participants. For example, assume that USP, FS1, and FS2 have an arrangement to develop software to market and install on customers’ systems. Although the parties intend to measure benefits based on projected sales, FS1 also intends to license the software to unrelated customers.

Therefore, the parties’ basis for measuring benefits is not the most reliable because all anticipated participants’ benefits have not been taken into account. Under such circumstances, the regulations suggest that operating profit might be more consistent and, therefore, more appropriate. In addition, absent a material change in the factors affecting the reliability of the estimate, the basis providing the most reliable estimate for a particular year should continue to provide the most reliable estimate in subsequent years.

The taxpayer may measure benefits either directly or indirectly. A direct basis employs references to estimated additional income to be earned or costs to be saved by the use of covered intangibles. An indirect basis employs references to certain

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63 *Id.*
64 Treas. Reg. § 1.482-7(f)(3)(ii).
measurements, described as follows, that can reasonably be assumed to be related to income generated or costs saved.\textsuperscript{67} Whether the taxpayer uses a direct or indirect basis, it must make appropriate adjustments to account for material differences among controlled participants in the activities they undertake to exploit their interests in the covered intangibles.\textsuperscript{68}

**Units Used, Produced, or Sold**

The taxpayer may decide to adopt units used, produced, or sold by each controlled participant as an indirect basis of measurement. This can be more reliable in situations where each controlled participant can expect a similar increase in net profit or decrease in net loss attributable to the covered intangibles based on such unit measures.\textsuperscript{69} This may be most appropriate where the participants exploit the intangibles in the use, production, or sale of substantially uniform items under similar economic conditions.

For example, assume that Foreign Parent (FP) and U.S. Subsidiaries (USS) both produce a feedstock for the manufacture of various high-performance plastics. The production process requires large amounts of electricity, which account for a significant portion of total production cost. FP and USS enter into a cost-sharing arrangement to develop a process that will reduce the amount of electricity required to produce a unit of the feedstock.

Even though the amount of savings is uncertain, both FP and USS expect to save approximately the same amount per unit produced because their current electric costs are essentially the same percentage of their total production costs, and they expect rates to remain similar in the future. Under such circumstances, an arrangement that shares costs on the basis of units produced should be acceptable as having the most reliable basis for measuring benefits and dividing the intangible development costs.\textsuperscript{70}

Alternatively, suppose that in the previous example, FP paid twice as high a percentage of its other production costs for electricity as USS. Initially, the IRS would reject units produced as the most reliable basis of measuring benefits because FP savings per unit produced will be twice USS’s savings per unit produced from any new process developed; however, if FP weights its units by a factor of 2, then the IRS would accept weighted units as the most reliable measure of benefits because the controlled participants have made appropriate adjustments for the material difference between their potential exploitation of their interest in the covered intangibles.\textsuperscript{71} If USS also had a somewhat different production process than FP so that it would cost USS more to adopt any newly developed process, then the IRS would reject units produced to measure benefits. In that case, the most reliable measure of benefits would

\textsuperscript{67} Id.

\textsuperscript{68} Id.

\textsuperscript{69} Treas. Reg. § 1.482-7(f)(3)(iii)(A).

\textsuperscript{70} Treas. Reg. § 1.482-7(f)(3)(iii)(E), Example 1.

\textsuperscript{71} Treas. Reg. § 1.482-7(f)(3)(iii)(E), Example 2.
offset the reasonably anticipated costs of adopting the new process against the reasonably anticipated total savings in electricity.\footnote{72 \textit{Treas. Reg.} § 1.482-7(f)(3)(iii)(E), Example 3.}

**Sales**

The sale of each controlled participant may be used as an indirect basis of measuring anticipated benefits. This basis of measurement is more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to covered intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting covered intangibles are not substantial relative to the revenues generated. Similarly, the principal effect of using covered intangibles is to increase the controlled participants’ revenues (e.g., through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring benefits unless each controlled participant operates at the same market level, such as manufacturing and wholesale distribution.\footnote{73 \textit{Treas. Reg.} § 1.482-7(f)(3)(iii)(B).}

In two of the regulation’s examples, FP and USS both manufacture and sell fertilizers. They enter into an arrangement to develop a new pellet form of a fertilizer that currently exists only in powder form. The pellet form will create delivery efficiencies with equivalent crop growth that will enable it to enjoy premium pricing. Anticipated sales in the United States and outside the United States will be used to measure anticipated benefits. Those things being equal, one example has both FP and USS operating at approximately the same market levels, selling their fertilizers primarily to independent distributors. In this case, sales were deemed the most reliable basis for measuring benefits.\footnote{74 \textit{Treas. Reg.} § 1.482-7(f)(3)(iii)(E), Example 5.} Alternately, where FP distributes its fertilizers directly and USS sells to independent distributors, the IRS will reject sales as the most reliable basis of measuring benefits unless the participants make adjustments to take into account the difference in market levels at which sales occur.\footnote{75 \textit{Treas. Reg.} § 1.482-7(f)(3)(iii)(E), Example 6.} Such “market level adjustments” require care both in development and documentation.

**Operating Profit**

Taxpayers may use the operating profit of each controlled participant from the activities in which covered intangibles are exploited as an indirect basis for measuring its anticipated benefits. This basis of measurement is more reliable to the extent that such profit is largely attributable to the use of covered intangibles or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when covered intangibles are integral to the activity that generates the profit and the activity could not be carried on, or would generate little profit without use of those intangibles.\footnote{76 \textit{Treas. Reg.} § 1.482-7(f)(3)(iii)(C).}
For example, where USP and FS cost share the development of a new human health medication, both will rely on covered intangibles to generate profit; however, where drug prices are uncontrolled in the United States but regulated in many other countries, anticipated operating profit from each patent under development provides a better measure of benefits than anticipated sales per participant.77

**Other Bases for Measuring Anticipated Benefits**

Other bases for measuring anticipated benefits may, in some circumstances, be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of covered intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected income from the controlled participants from the use of covered intangibles.78

In the Regulations, FP and USS enter into a cost-sharing arrangement to develop materials that will be used to train all new entry-level employees. In this example, FP and USS determine that the new materials will save approximately 10 hours of training per employee. Because they pay their entry-level employees on different wage scales, FP and USS use compensation paid to entry-level employees hired by each rather than the number of entry-level employees hired by each. The IRS will accept this as the most reliable measure of benefits because of the direct relationship between the compensation paid to and costs saved from using the new training materials for new hires.79

**COMPARING PROJECTED TO ACTUAL BENEFITS**

The reliability of an estimate of anticipated benefits depends upon the reliability of the projections used in making the estimate. Such projections will generally include estimates of the following:80

- The time period between the inception of the research and development and the receipt of benefits
- The time over which the benefits will be received
- The amount of anticipated benefits expected yearly during that period

Likewise, a projection of the relevant basis for measuring benefits may require the taxpayer to project the factors underlying that basis. For example, a projection of operating profit may require projections of sales, cost of sales, operating expenses, and other factors that affect operating profits.81

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81 Id.
Stable Benefit Shares Anticipated

If benefit shares are anticipated to remain relatively stable over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares, always subject to examination. The Treasury Regulations state that this is not likely to occur when five factors are present:82

1. The cost-sharing arrangement is a long-term arrangement.
2. The arrangement covers a wide variety of intangibles.
3. The composition of the covered intangibles is unlikely to change.
4. The covered intangibles are unlikely to generate unusual profits.
5. Each controlled participant’s share of the market is stable.

Assume that USP and FS are participants to a cost-sharing agreement to develop new household cleaning products, have extensive experience in that market, have stable market shares, and are researching products unlikely to generate exceptional profits. Under such circumstances, the participants’ use of current sales of cleaning products to project their anticipated future benefit shares will be viewed by the IRS as generating reliable projections.83

Variable Benefit Shares Anticipated

The taxpayer may anticipate that there will be significant variation among the controlled participants in the timing of their receipt of benefits and, consequently, that the participants’ benefit shares are expected to vary significantly over the years in which participants receive benefits. Under such circumstances, the taxpayer may need to use the discounted value of the projected benefits to reliably determine each controlled participant’s share of those benefits.84 The discount rate chosen should be based on the risk associated with the venture.85

Thus, in the previous example, if FS’s market share were rapidly expanding because of a competitor’s business failure in its geographic area and the other facts remained constant, the IRS would view FS’s use of current sales to project future benefit shares as unreliable and require FS to take its growth in sales into account.86 Although the regulations suggest no specific remedy in this example, the clear implication is to project USP’s sales over a relevant period using USP’s stable market share, project FS’s sales over a relevant period with an expanding market share for part or all of the period, and to discount the results to achieve a present value of the future anticipated benefits.

In another example, the IRS suggests that a similar need to discount the results could occur where FP and USS anticipate spending the same amount of time both

82 Id.
developing a new model car as well as manufacturing and selling such new models, but where USS typically begins producing and selling new car models one year after FP.87 In this example, FP and USS had used total projected sales over the four-year sales period without any discounting to project anticipated benefits to determine cost shares. This example is silent as to the result if the one-year lag on introducing new model cars did not exist.

Hybrid situations may exist where cost-sharing arrangements have stable and variable circumstances existing in different products or product lines and it is possible to measure each separately. Assume that FP and USS attempt to use current sales of fertilizers and insecticides to share costs when market shares for both are stable for fertilizer, but FP’s market share for fertilizers has been expanding. In this case, the IRS will allow the fertilizer methodology but will require insecticides to take the expanding market share into account.88 This clearly requires the ability to separately measure the future anticipated benefits of each.

### TESTING PROJECTED TO ACTUAL BENEFITS

The IRS acknowledges that projected benefit shares and actual benefit shares will be different. Like the two sides of a single coin, the degree of difference between projected and actual benefits creates an issue that may be addressed from two viewpoints: (1) Is the difference small enough for the cost shares to be respected as reliable or, (2) is the difference so large as to render the projections unreliable and require an adjustment?

#### 20 Percent Rule: Success

The regulations adopt the position that the participants must first demonstrate that they used the most reliable basis for measuring anticipated benefits (e.g., units, sales, operating profit, or another measure). If the participants meet this form of “best method” analogy, then the IRS will respect the controlled participant’s cost share when the variance between its projected benefits share and actual benefits share is less than or equal to 20 percent.89 For example, assume that USP and FS enter into a cost-sharing agreement to develop new food products, dividing costs on the basis of projected sales two years in the future, and estimate in Year 1 that their Year 3 sales will be equal. When the IRS examines the arrangement, it first reviews and accepts as reliable the sales in Year N+2 basis of projecting future anticipated benefits. Only after this evaluation does it conclude that the projection of future benefits for Year 5 is reliable where USP and FS accounted for 58 percent and 42 percent of sales, respectively, and that the variance from the 50 percent/50 percent projected sales was less than 20 percent.90

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Aggregating Foreign-Controlled Parties

For purposes of the 20 percent test, all controlled participants who are not U.S. persons are aggregated into a single controlled participant. The U.S. consolidated tax return group is treated as a single participant. This rule simplifies the overall tests of projected to actual benefits. Although subject to further scrutiny discussed as follows, this can also have a beneficial effect when multiple foreign-controlled participants exist. Assume the following projected and actual benefit shares shown in Figure 9.1.

In this case, if FS2 were viewed in isolation, it would fail the 20 percent test; however, by aggregating all non-U.S. persons, their total share of actual benefits (55 percent) is within the 20 percent allowable variance from their total share of projected benefits (50 percent), and the example tentatively concludes that the cost shares are reliable. Therefore, this rule has the general effect of confirming adjustments to the cost shares of foreign-controlled participants to situations where there is a matching adjustment to the cost shares of U.S.-controlled participants.

Foreign-to-Foreign Adjustments

Notwithstanding the foreign-controlled participant aggregation rule’s general effect in the prior sentence, the IRS reserves the right to make foreign-to-foreign adjustments if the variance between actual and projected benefits also has the effect of substantially reducing U.S. tax. To demonstrate this, assume that the IRS discovered in the prior example that FS1 was profitable with earnings and profits but that FS2 had both losses and no earnings and profits. The IRS might then conclude, based on all the facts and circumstances, that FS1’s cost share was arranged to be larger than appropriate in order to reduce FS1’s earnings and profits and potential subpart F inclusions. In that case, the IRS might adjust the cost shares of only FS1 and FS2.

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**FIGURE 9.1 Projected and Actual Benefit Shares**

<table>
<thead>
<tr>
<th>Controlled Participant</th>
<th>Projected Benefit Share %</th>
<th>Actual Benefit Share %</th>
<th>Variance %</th>
</tr>
</thead>
<tbody>
<tr>
<td>USP</td>
<td>50</td>
<td>45</td>
<td>10</td>
</tr>
<tr>
<td>FS1</td>
<td>30</td>
<td>25</td>
<td>16(\frac{2}{3})</td>
</tr>
<tr>
<td>FS2</td>
<td>20</td>
<td>30</td>
<td>50</td>
</tr>
</tbody>
</table>

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92 See the “Qualified Cost-Sharing Arrangement Defined” section.
CONSEQUENCES OF FAILING THE 20 PERCENT TEST

If the controlled participant’s projected benefit share and actual benefit share vary by more than 20 percent, the taxpayer has one final, faint hope of avoiding an IRS adjustment. The district director will not make an allocation when the variance is greater than 20 percent if the difference is caused by an extraordinary event, beyond the control of the participants, that could not reasonably have been anticipated at the time the costs were shared.97 Unfortunately, the regulations provide no further elaboration or examples. Otherwise, a greater than 20 percent variance between projected and actual benefit shares generally provides the IRS the ability to consider alternative adjustments.

Using Actual Benefits

The simplest adjustment upon failing the 20 percent test is to substitute actual benefit shares for projected benefit shares and then reallocate cost shares among participants accordingly. Assume that the example in the “Comparing Projected to Actual Benefits” section still has USP and FS splitting costs 50 percent/50 percent in Year 1 based on projected equal sales in Year 3. Even though the IRS accepts using sales in Year N+2 as a reliable basis for estimating benefit shares, further assume that the actual Year 3 sales are 35 percent USP and 65 percent FS and that the extraordinary event exception does not apply. Thus both USP and FS have variances between actual and projected benefits in excess of 20 percent. As a result, the IRS concludes that the projection of anticipated benefits was unreliable and uses actual benefits as the basis for adjusting the cost shares borne by USP and FS.98

An adjustment to actual results may arise even when only one controlled participant fails the 20 percent test. One of the regulation’s examples has USP and FS anticipating benefits (and therefore sharing costs) on a 60 percent USP/40 percent FS basis but, after accepting the basis for the projections, the IRS finds that the actual benefits are equal. In this case, USP’s actual benefit share (50 percent) is within 20 percent of its projected benefit share (60 percent), but FS’s actual benefit share (50 percent) is not within 20 percent of its projected benefit share. Under such circumstances, the IRS may conclude that the participants’ projections were not reliable and may use actual benefits as the basis for an adjustment to the cost shares borne by USP and FS.99 Given the U.S. consolidation and foreign aggregation rules, it is necessary to adjust USP even though it passed the 20 percent test in order to also adjust FS.

Initial Failure Generates a Second Look

If the controlled participants project benefits over a period of years, and the projections for the initial years prove unreliable, one would normally expect an adjustment

to actual for those years at the very least. Nevertheless, the IRS has created an example with failure in the early years, no extraordinary event, and ultimately no adjustment based on a closer examination of facts available in a longer term arrangement.

In this case, FP and USS enter into a cost-sharing arrangement in 1996 to develop a new treatment for baldness. They measure their anticipated benefits using their respective shares of projected sales from 1997 through 2006, discounted at an interest rate commensurate with the risk of the venture. In 2002, the IRS examines the arrangement and has sales results through 2001. USS’s sales grew more slowly than projected, and FP’s sales grew faster than projected. In each of the first three years, the share of total sales of at least one of the parties varied by more than 20 percent from its projected share of sales. Rather than stopping here and adjusting to actual sales, the IRS also sees that by 2001 both parties’ sales had leveled off at approximately their projected values. As a result, the IRS retests the projection by combining known actual sales through 2001 with projected sales for the period 2002–2006. Applying an appropriate discount rate, the IRS recalculates the present discounted value of the sales. The result is revised anticipated benefit shares, which vary less than 20 percent with the original projections. Therefore, the IRS proposes no adjustment.\footnote{100}

While appreciating the longer-term view taken by the IRS in this example, it does raise some potentially disturbing questions. For example, what if the IRS examined the arrangement in 2000 after only three years of sales data and consistent failure of the 20 percent test by at least one of the parties from its projected sales shares? To a certain extent, the regulations may already answer this question.

**Using Actual Results and Revising Projections**

When benefits are projected over a period of years, and the projections for the initial years of the period prove unreliable, this may indicate that the projections for the remaining years are also unreliable and thus should be adjusted.\footnote{101} Using virtually the same initial facts for the first three years results as the prior example, the regulations go on in another example in which the actual results for the most recent two years (i.e., 2000 and 2001) enlarge the disparity between USS and FP. As a result, the IRS generates revised projections for the five remaining years using amounts it deems are more reliable. The IRS then combines the actual results through 2001 with its own revised projections for 2002 through 2006 and discounts the streams of sales using an appropriate discount rate. The IRS’s revised calculation of anticipated benefits varies by more than 20 percent from the original projections. Therefore, the IRS views the original projections as unreliable and adjusts cost shares for each of the taxable years under examination to reflect the recalculated shares of anticipated benefits.\footnote{102}

\footnote{100} Treas. Reg. § 1.482-7(f)(3)(iv)(D), Example 10.
\footnote{102} Treas. Reg. § 1.482-7(f)(3)(iv)(D), Example 11.
Timing of Allocations

If the IRS proposes a change in cost allocations, the reallocation must be reflected for tax purposes in the year in which the costs were incurred. Here the Final Regulations represent a significant change from the 1992 Proposed Regulations, which generally treated IRS allocations as income in the taxable year under review, even if the costs being allocated had been incurred in a prior year. The IRS will also impute an arm’s-length interest charge for the time value of the money owed from the original date for payment.

BUY-INS AND BUYOUTS

Most cost-sharing arrangements require the transfer of one or more pre-existing intangibles. Many attempts to form cost-sharing arrangements also break down over the need for other potential cost-sharing members to compensate the owner of the preexisting intangible (the “buy-in”). Even if the parties conceptually agree to the buy-in, the next and significantly more difficult issue is agreeing on a value for the amount of the buy-in payment. This is particularly true where prior research has not yet generated a marketable product. Buy-in situations also can occur when a new participant joins an existing cost-sharing arrangement as well as when an existing participant relinquishes all or part of its interest under the arrangement.

“Preexisting Intangibles”

When one controlled participant makes intangible property in which it owns an interest available to the other controlled participants in and as part of a qualified cost-sharing arrangement, then each of the others must make a buy-in payment to that owner. Each other participant’s buy-in payment equals the total arm’s-length charge from the owner to the qualified cost-sharing arrangement multiplied by that participant’s share of reasonably anticipated benefits.

For example, assume that A contributes the use of a patent to a qualified cost-sharing arrangement among A, B, and C. The controlled participants expect to share anticipated benefits A 30 percent; B 50 percent, and C 20 percent, and the arm’s-length charge for the taxable year for the use of the patent made available to the arrangement is 100S. As a result, the buy-in payment for the taxable year for B is (.50 × 100S) = 50S and for C is (.20 × 100S) = 20S. In effect, the buy-in payment creates the equivalent of an additional cost-sharing payment by each non-owner-controlled participant.

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103 Treas. Reg. § 1.482-7(f)(4).
106 Treas. Reg. § 1.482-7(g)(2).
107 See Treas. Reg. § 1.482-1 and Treas. Reg. § 1.482-4 to 1.482-6 concerning the transfer or use of intangible property.
108 Treas. Reg. § 1.482-7(g)(2).
participant; however, the buy-in payment(s) may be in the form of lump sum payments, installment payments, and royalties. Nevertheless, the controversy over the need to include share-based compensation in the pool of operating costs to be shared has also affected the service’s concept of the appropriateness of a buy-in where a company’s R&D employees received share-based compensation.

Netting is also permitted; that is, a controlled participant may reduce its payments to the extent of payments owed to it by other controlled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. This is important for tracking purposes when multiple parties make available multiple intangibles to the qualified cost-sharing arrangement. It is also consistent with the notion that such payments are treated as consideration for a transfer of an interest in the intangible property made available by the owner to the qualified cost-sharing arrangement.

Any buy-in payment to or from an uncontrolled participant will be shared by the controlled participants according to their respective shares of reasonably anticipated benefits. Netting also applies so that a controlled participant’s required payment is deemed to be reduced by its share of amounts owned from uncontrolled participants. Taken in the overall context of the regulations, this creates an indirect method of compensating a controlled participant who contributes an intangible to the arrangement when the arrangement also has an uncontrolled participant. The regulations provide an example with uncontrolled party C making a payment for technology made available by A, where A and B are controlled participants. Instead of simply having C pay A its share, the example first splits the payment from C between A and B based on their respective shares of anticipated benefits and then nets B’s payment from C against the payment B owes A. The result, at least in this example, is the same mathematically but the step is apparently necessary to avoid creating confusion given the way the buy-in rules apply to controlled participants.

New Controlled Participant

When a new controlled participant enters a qualified cost-sharing arrangement and acquires any interest in the covered intangibles, the new participant must pay an arm’s-length consideration to each controlled participant from whom such interest was acquired. Because new participants usually enter arrangements one or more years after the arrangement begins, it requires the controlled participants to first value all of the covered intangibles under the arrangements and then to match the buy-in payment calculated from that value and the new participant’s interest with the appropriate “selling” controlled participant(s).

109 Treas. Reg. § 1.482-7(g)(7) and see Treas. Reg. § 1.482-7(g)(8), Example 3.
110 See Treas. Reg. § 1.482-7(g)(8), Example 4.
111 Treas. Reg. § 1.482-7(g)(2).
112 See Treas. Reg. § 1.482-7(g)(8), Example 5.
113 Treas. Reg. § 1.482-7(g)(3).
114 See Treas. Reg. § 1.482-7(g)(8), Example 1.
Controlled Participant Relinquishes Interests

Buyouts occur when a controlled participant transfers, abandons, or otherwise relinquishes an interest deemed acquired under a qualified cost-sharing arrangement. In that case, the relinquishing participant must receive arm’s-length consideration for its interest.115

The notion of “relinquish” seems broad enough that one example in the regulations reaches this result when USS manufactures Group X products and participates in an arrangement but decides to switch from manufacturing Group X products to purchasing them instead from another controlled participant for U.S. resale at a distributor’s profit margin.116 This result potentially could have been avoided, even though USS stopped manufacturing Group X products itself, as long as it had them produced under a contract manufacturing arrangement that preserved its profit from the developed manufacturing intangibles. That, however, was not the way the IRS created the fact pattern.

Conduct Inconsistent with a Cost-Sharing Arrangement

The IRS may reallocate costs if the arrangement’s projected benefit shares fails the 20 percent test when compared with actual benefit shares and are therefore unreliable. It may occur, however, that a controlled participant bears costs of intangible development over a period of years, which are inconsistent with the participant’s share of benefits. Under such circumstances, the IRS may conclude that the economic substance of the arrangement is inconsistent with the terms of the arrangement. In that case, the IRS may disregard the arrangement’s terms and impute an agreement consistent with the parties’ course of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles.117 As a result, that participant must receive an arm’s-length payment from any controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time.118 In effect, it creates a revised agreement with an imputed buy-in.

Failure to Assign Interest

If a qualified cost-sharing arrangement fails to assign an interest in a covered intangible, existing cost shares of each participant will determine how each participant is deemed to hold a share in that interest.119 Discounted present value calculations are appropriate in such situations if costs have varied materially over the period during which such intangible was developed.120

115 Treas. Reg. § 1.482-7(g)(4).
116 See Treas. Reg. § 1.482-7(g)(8), Example 2.
117 Treas. Reg. § 1.482-7(g)(5).
118 Id.
119 Treas. Reg. § 1.482-7(g)(6).
120 Id.
CHARACTER OF PAYMENTS

Payments made under qualified cost-sharing arrangements (other than buy-in payments) are generally considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee.

As previously noted, each payment received by a payee will be treated as coming pro rata out of payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the qualified cost-sharing arrangement. Payments received in excess of such deductions will be treated as in consideration for use of the tangible property made available to the qualified cost-sharing arrangement by the payee. To demonstrate this, assume that costs borne by USP are 5S of operating expenses and 95S for the fair rental value of a facility, where USP’s depreciation deduction for the facility is 7S. If USP receives a net payment of 20S, it reduces operating expenses by 5S, reduces the depreciation deduction by 7S, and then treats the remaining 8S as rent for use of the U.S. facility.

U.S. Recipient

Assume that USP performs all the research and development under the qualified cost-sharing arrangement and receives cost-sharing payments from certain of its foreign subsidiaries. Rather than being treated as income, the payments it receives will reduce its R&D expense deduction, but they will not reduce R&D expenses for purposes of the credit for increasing R&E expenses under Section 41. Consistent with the reduced expense deduction, the R&D expenses apportionable for foreign tax credit purposes will start from that same reduced amount, with 100 percent of the expense performed in the United States to the extent the apportionment rules have a place of performance bias consistent with Treasury Regulation 1.861-17.

This is consistent with the new paradigm that occurs when a U.S. parent switches from its traditional develop and license strategy to cost sharing. Assuming all R&D is performed in the United States, the old royalty stream reduces over time. Simultaneously, in this scenario, cash flow to the United States continues as part old royalty payments and part new cost-sharing payments, but the cost-sharing payments are not part of foreign source income for foreign tax credit purposes. Therefore, U.S.-based multinationals need to consider all the ramifications of adopting a qualified cost-sharing arrangement, including the possibility of getting a cost-sharing Advance Pricing Agreement.

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121 Treas. Reg. § 1.482-7(h).
122 See Treas. Reg. § 1.482-7(h)(2), Example 2.
123 Treas. Reg. §§ 1.482-7(h)(1) and 1.41-8(e).
124 Treas. Reg. § 1.482-7(h)(2), Example 1.
U.S. Payor

If a U.S. member of a qualified cost-sharing arrangement makes a payment, it has a valid deductible expense.\textsuperscript{125} The amount of the payment does not, however, create an expense for R&E credit purposes because it is eliminated under the intergroup rules.\textsuperscript{126} In addition, U.S. withholding tax should not apply to cost-sharing payments. This is consistent with the notion of a payor acquiring an interest in an intangible and the recipient having a cost reduction, rather than income.

CONCLUSION

Cost sharing may provide related groups with a variety of opportunities; however, the taxpayer must carefully develop the factual basis and carefully analyze the alternatives as well as their related consequences.

\textsuperscript{125} 26 USC § 174.  
\textsuperscript{126} 26 USC § 41(f)(1).
Regulations promulgated in July 1994 provide two profit split methods, not three methods as under the proposed regulations.

**CHANGES IN THE REGULATIONS**

The 1994 final regulations eliminated three significant limitations contained in the 1993 proposed regulations:

1. The final regulations elevate the profit split method to a “specified” method. As a result, the profit split method qualifies for the reasonable cause exception to the Section 6662(e) accuracy-related penalties. A taxpayer cannot reasonably conclude that the method it selected provided the most reliable measure of an arm’s-length result if it has not made a reasonable effort to evaluate the potential applicability of the other specified methods under the Section 482 regulations in a manner consistent with the principles of the best method rule.¹

2. The 1994 final regulations delete the requirements in the 1993 proposed regulations that each party to the transaction contribute valuable, nonroutine intangible property, and that the intangible property contribute significantly to the combined operating profit of the controlled group.

3. It is no longer necessary to make a binding election to use a profit split method.²

**BASIC PREMISE FOR THE USE OF PROFIT SPLITS**

The underlying premise of the final regulations is that profit (or loss) allocation is determined by reference to the relative value of each participant’s contribution to the combined profit (or loss). Combined operating profit is derived from the most narrowly identifiable business activity, or segment, of the controlled group from which data is available.³

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¹ Treas. Reg. §1.6662-6(d).
² See Preamble, Treas. Reg. §1.482-6.
³ Treas. Reg. §1.482-6(a).
Each controlled taxpayer is to determine its appropriate share of profits (or losses) in a manner that reflects the functions performed, the risks assumed, and resources employed by each participant in the relevant business activity. Allocation should reflect economic reality, which could result in allocation of profit to one participant and loss to another.4

The regulations provide two specific profit split methods:

1. The comparable profit split method
2. The residual profit split method

Other profit split methods may be employed under the “other” method provisions. The capital employed allocation method, a third profit split approach contained in the proposed regulations, was deleted from the final regulations. The preamble to the final regulations states that this method was eliminated as a specified method because of practical difficulties in its application. The capital employed allocation method allocated the same rate of return to all assets employed in the relevant business activity, which requires sharing profits in proportion to the participants’ risks. The preamble states that it was possible in only one case to determine when controlled taxpayers faced equal levels of risk, which would be required to establish a level rate of return.

**COMPARABLE PROFIT SPLIT METHOD**

The comparable profit split method depends on the profit on comparable transactions between two unrelated enterprises.5 As a result, few taxpayers will be able to rely on this method. The purpose of the comparable profit split method is to divide operating profits among the controlled taxpayers in amounts similar to those arising from uncontrolled transactions. Strict standards for comparability are set forth in Treasury Regulation Section 1.482-1(d). In particular, comparability is to be determined by an analysis of the allocation of operating profits of controlled and uncontrolled taxpayers, and the similarity of the contractual terms. The final regulations state that the comparable profit split method may not be used if the “combined operating profit as a percentage of the combined assets of the uncontrolled taxpayers varies significantly” from that of the controlled taxpayers.6 Guidance is provided for adjustments to differences in transactions between controlled and uncontrolled taxpayers, generally determined by reference to a direct allocation of costs, income, and assets among the participants as well as the quality of data and reliability of assumptions.7

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4 Treas. Reg. §1.482-6(b).
5 This is not the CPM, which is discussed in detail at Chapter 9.
7 Treas. Reg. §§1.482-6(c)(2)(ii)(B) and 1.482-6(c)(2)(ii)(C).
RESIDUAL PROFIT METHOD

The second profit split method is the residual profit method. Under this method, the combined operating profit or loss from the relevant business activity is allocated between controlled taxpayers in a two-step process:8

1. Operating income is allocated to each participant in a manner that will yield a market return to the participant for routine contributions to the business activity.
2. Residual profit that is attributable to the controlled group’s valuable intangible property is apportioned.

The taxpayer must find comparables under the residual profit split method as with other transfer pricing methods.9 One of the most difficult problems in an actual transfer pricing case is finding comparables, particularly with respect to activities carried on in foreign countries.

Allocation of Income and the Residual Profit Split

For purposes of the allocation of income, routine contributions are defined as “contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns.”10 Functional analysis is required in order to identify the functions performed and resources employed by each of the entities involved. Then the taxpayer values these amounts by reference to third-party criteria so as to quantify the respective contributions.

Each participant then obtains a rate of return based on market returns of uncontrolled taxpayers. Market returns of uncontrolled taxpayers are determined by reference to any other specified method (e.g., the comparable uncontrolled transaction method or the comparable profits method).11

Apportionment and the Residual Profit Split

The second step in the residual profit method is to apportion the residual profit. A residual profit remains after allocation under the first step where valuable items of intangible property are owned by the controlled group, but similar items are not owned by the uncontrolled taxpayers from whom the market returns were derived. Residual profit is to be allocated and/or apportioned in accordance with the relative values of the intangible property in the hands of one or more of the relevant affiliates. Three methods for apportionment are set forth, although it is not clear whether the list is exclusive.12

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8 Treas. Reg. §1.482-6(c)(3)(i).
9 Id.
11 Id.
1. The relative values of the item or items of intangible property may be measured by external “market benchmarks.” The regulations do not define this term. The IRS informally indicated that market benchmarks refer to external data involving uncontrolled taxpayers or uncontrolled transactions.

2. The relative values of the item or items of intangible property may be estimated by the capitalized cost of originally developing the property, plus the cost of developing all related improvements and updates, less amortization, based on the useful life of each intangible. The regulations reserve on the reliability of this capital cost method, although it is used in the only example given on computation of a profit split.

3. Finally, if research and development expenditures of the parties are relatively constant and the useful life is approximately the same, actual expenses may be used to determine the relative value of each item of intangible property.13

**Comparability and Reliability**

Profit splits depend on comparability and reliability. The first step of the residual profit split method relies on market benchmarks. Factors that determine market returns for routine contributions are of primary importance in determining comparability. The reliability of the residual profit method is reduced to the extent that step two does not rely on market benchmarks.14

An allocation based on capitalized costs may not necessarily be the most reliable for several important reasons.

- Development cost involved bears little relation to market value. A higher research and development output will not necessarily mean higher market value. In fact, the opposite is more apt to be the truth.
- Calculation of capitalized costs may require allocation of indirect costs among the controlled taxpayer’s activities; this allocation could affect reliability.
- Calculation of costs could involve unfounded and unreliable assumptions about the useful life of the property.15

**THE NULON EXAMPLE**

XYZ is a U.S. corporation that develops, manufactures, and markets products for police use in the United States XYZ developed a bulletproof material, Nulon, and obtained patent protection for the underlying chemical formula. The Nulon product has captured a substantial portion of the U.S. market. The example contained in the final regulations differs from the example in the proposed regulations only in the product it describes.

XYZ-Europe is a well-established subsidiary of XYZ. XYZ licenses XYZ-

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13 *Id.*
15 Treas. Reg. § 1.482-6(c)(3)(ii)(C).
Europe to manufacture and market Nulon in Europe. XYZ-Europe adapts XYZ’s products for the European defense market. XYZ-Europe also has a well-developed marketing network that develops brand names and markets products under those names. XYZ-Europe adapts Nulon for military use in Europe’s defense industry, marketing it under a brand name XYZ-Europe developed.

XYZ has no direct expenses in 1995 for licensing Nulon or marketing it in Europe. XYZ-Europe’s sales for 1995 were $500 million, and its preroyalty expenses were $300 million, which results in a preroyalty profit of $200 million.

The portion of XYZ-Europe’s operating assets devoted to its Nulon business are stated to be $200 million. Under the first step of the residual profit method, it is determined that, based on a comparison of European companies performing functions similar to those of XYZ-Europe, an average rate of return on assets is 10 percent, resulting in a market return of $20 million ($200 \times 10\% = $20) to XYZ-Europe.

The residual $180 million ($200 – $20 = $180) is attributable to valuable intangible property, namely, the Nulon formula as adopted for the European market through specific modifications and use of the European brand name. The residual profit is properly apportioned by comparing the ratios of the capitalized value of the expenditures through 1995 on Nulon-related research and development (R&D) incurred by XYZ and XYZ-Europe. Marketing expenditures incurred by XYZ-Europe for 1995 sales related to these expenses are included.

XYZ’s Nulon-related R&D expenses support its worldwide sales, so it is “reasonable” to allocate the value of those expenses based on worldwide sales. The proposed regulations assumed a figure of $0.20 per dollar without any explanation. The final regulations state that such expenses can be capitalized and amortized based on the average useful life of its investment in protective product R&D. Capitalized R&D expenses are thereby determined to have a value of $0.20 per dollar of protective product sales for 1995.

A similar analysis is made for XYZ-Europe’s R&D and marketing expenses. These expenses, however, support its sales only in Europe. Once capitalized and amortized, the figures result in a value for 1995 of $0.40 per dollar of XYZ-Europe’s Nulon sales.

Jointly, XYZ and XYZ-Europe contributed $0.60 for each dollar of 1995 sales. XYZ contributed one-third of the $0.60. Accordingly, using the sales contribution ratio, one-third of the residual income of $180 million is allocated to XYZ as an arm’s-length royalty for 1995.16

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**BEST METHOD ANALYSIS FOR THE PROFIT SPLIT APPROACH**

Unlike the proposed regulations, the final regulations contain two examples indicating when a profit split approach is or is not the best method. The first example

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16 Treas. Reg. §1.482-6(c)(3)(iii).
describes the residual profit split method. USC is a U.S. company that develops, manufactures, and sells communications equipment. EC is an established European subsidiary that performs the same functions in Europe. There are extensive transactions between USC and EC. USC developed valuable technology and licensed that technology to EC. EC also licenses its technology to USC.

Detailed accounting information is available for USC and EC, and reasonably reliable allocations of costs, income, and assets can be made. Relevant market and R&D expenses can be identified. Reasonable estimates of the useful life of the related intangibles are available so that capitalized values can be calculated. Comparables are available that could be used to estimate a market return for routine contributions.

There are no uncontrolled transactions on which to base an allocation under any other method specified in the regulations. Given the difficulties of applying any other transfer pricing method and the reliability of the internal data of USC and EC, the example concludes that the residual profit split method is the best method under the circumstances.

The second example demonstrates a situation in which the CPM is the best method. One controlled party contributed valuable, nonroutine intangibles, and the other party contributed routine manufacturing and marketing activities. The decisive factor in selecting the CPM is that several similar uncontrolled companies could provide a rate of return on the routine manufacturing and marketing activities.

17 Treas. Reg. §1.482-8, Example 8.
18 Id., Example 9.
Focus on International Transfer Pricing Issues
Foreign-owned U.S. corporations are facing the wrath of the U.S. tax authorities. A foreign-owned U.S. corporation, its parent company, and other affiliates of the U.S. corporation are subjected to new reporting responsibilities. In addition, U.S.-owned businesses are subject to a significant portion of these requirements if the U.S.-owned business is attempting to avoid the transfer pricing penalty. If a foreign corporation has a subsidiary in the United States, this subsidiary (termed a “reporting corporation”) must retain records and report to the Internal Revenue Service (IRS) any significant transaction with the parent corporation or one of its non-U.S. subsidiaries. These rules were promulgated as Treasury Regulations in June 1991, implementing the Revenue Reconciliation Act of 1989. Enforcement of these provisions is increasing rapidly.

BACKGROUND

The regulations were precipitated by aggregate intercompany transfer pricing data that was adverse from the standpoint of the United States. This intercompany transfer pricing data had indicated that U.S. companies and the IRS were both losing out to foreign-headquartered corporations and to foreign tax authorities, often because of predatory transfer pricing policies. While gross receipts from foreign-owned U.S. corporations have steadily increased, U.S. taxable income from these corporations has declined as a percentage of gross receipts. As a result, Treasury Regulations emphasize extensive record keeping and reporting to the IRS. The IRS is now

2 Act §§ 7403(a)(2) and 7403(d), amending I.R.C. § 6038A.
empowered to conduct more thorough and extensive tax audits, which are leading to pricing adjustments, penalties, and disallowance of deductions for costs and expenses in noncompliance situations.

**REGULATIONS**

These IRS regulations are nearly 100 pages in length and require a foreign-owned corporation to establish extensive data collection and report to the IRS. A variety of complex computations are needed to complete various tax forms, attachments, and schedules. The IRS, by its own estimate, expects foreign-owned corporations to utilize more than 1.5 million hours of work product per year just to fulfill the record maintenance and information collection obligations.

A taxpayer is obligated to provide the IRS with information concerning each related party. Aggregate data for the related-party group as a whole is insufficient. The regulations:

- Require tax reporting.\(^3\)
- Specify records to be retained and analyzed.\(^4\)
- Indicate potential penalties.\(^5\)
- Provide agency authorization.\(^6\)
- Specify summons procedures.\(^7\)
- Provide for noncompliance.\(^8\)

**PARTIES AFFECTED**

U.S. corporations that are owned by non-U.S. parties are obligated to report their intercompany transactions to the IRS. Similarly, non-U.S. corporations that are engaged in a trade or business in the United States must also file their transactional data. This IRS filing is mandatory, even though the corporation already is obligated to file its corporate income tax return. In addition, the regulations require non-U.S. shareholders of such a corporation to retain their own documents and data.\(^8\)

Before the current regulations, banking, financing, and similar businesses were exempt from IRS foreign tax reporting requirements. These rules apply to all foreign-owned corporations.

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4 *Id.*, “Penalties.”
5 *Id.*, “‘Limited Agency’ Agreements.”
6 *Id.*, “Summons Procedure.”
7 *Id.*, “Formal Document Request Procedure.”
8 Treas. Reg. § 1.6038A-1(b).
REPORTING CORPORATIONS AND RELATED PARTIES

Reporting requirements have been enhanced by regulations issued in June 1991, compared with the regulations issued in 1985. Schedules, attachments, and computations are now required. As a result, the IRS is increasing its international audit staff. Related-party transactions with the foreign-owned U.S. company are described in Form 5472. Specific information is required for imports into the United States. The U.S. corporation must provide the IRS with information concerning each related party. Aggregate data for the related-party group is insufficient.

A corporation that reports to the IRS under these provisions is typically a domestic corporation that is 25 percent or more foreign owned. A foreign corporation engaged in trade or business within the United States is treated analogously to a domestic corporation in applying the “reporting corporation” threshold. The 25 percent threshold is based on total voting power or value. The reporting corporation must report to the IRS using Form 5472 if a relationship to a related party occurs at any time during the taxable year.

Form 5472 reflects intercompany transactions between the reporting corporation and the related party. In essence, a related party is the corporate affiliate of the reporting corporation. This related party includes any 25 percent foreign shareholder of the reporting corporation or any person who is related to the reporting corporation or the 25 percent shareholder. A reporting corporation is a related party if it is related to the reporting corporation within the meaning of the transfer pricing provisions of Internal Revenue Code (IRC) Section 482.

TAX REPORTING REQUIREMENTS

Before the Revenue Reconciliation Act of 1989, tax reporting to the IRS had been required, but reporting requirements are significantly enhanced by regulations issued in June 1991. Schedules, attachments, and computations are required, and the IRS is increasing its international audit activities accordingly.

Related Parties

Related-party transactions with the foreign-owned U.S. corporation are the crux of Form 5472. Separate provisions in the regulations apply to monetary transactions with a related party and to nonmonetary transactions with the related party. In either situation, the transactions must often be analyzed and computed.

Most intercompany transactions must be reported on Form 5472, but other

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9 Treas. Reg. § 1.6038A-1(c).
10 Treas. Reg. § 1.6038A-1(d).
transactions are excluded.\textsuperscript{14} Almost all of the enumerated categories pertain to income statement items, but some balance sheet items are also included. These categories include such items as sales and purchases, rents and royalties, commissions, and loans and interest.\textsuperscript{15} Specific information is required for imports into the United States.\textsuperscript{16}

**Currency and Language**

U.S. dollar amounts must be used for IRS reporting purposes, even if foreign currency is actually used for the transactions. U.S. currency translation rules apply for this purpose.\textsuperscript{17} When nonmonetary amounts are uncertain, approximations may be used to determine reasonable estimates. Estimates are considered reasonable if they range between 75 percent and 125 percent of the actual amount, as ultimately determined by the IRS and the courts.\textsuperscript{18}

The English language must be used for all U.S. tax purposes, and translation of these records can be compelled by the IRS on short notice, typically 30 to 60 days.\textsuperscript{19} Extensions of time may be granted.\textsuperscript{20}

**RECORDS AND COMPUTATIONS**

The regulations require extensive records on the part of the U.S. corporation and its foreign related parties. These provisions are the central focus of regulations, particularly because additional computations pertaining to the U.S. subsidiary may be required to be made. Nearly 100 specific records may be required. These record requirements are retroactive, typically to March 20, 1990, but in some situations to July 10, 1989.

**Scope**

The scope of these regulations is pervasive, and the IRS can require records “that are sufficient to establish the correctness of the federal income tax return.”\textsuperscript{21} In the U.S. tax system, amounts are self-assessed, but “correctness” of the income is up to the IRS and the courts.

For a foreign related party, the regulations are even more pervasive. The standard requirement is that records “may be relevant” to the determination of the correct treatment for intercompany transactions between the U.S. corporation and the foreign related party. The determination of relevancy, according to the Treasury Regulations, is up to the IRS and the courts.

\textsuperscript{14} Treas. Reg. § 1.6038A-2(f)(1).
\textsuperscript{15} Treas. Reg. § 1.6038A-2(b)(3).
\textsuperscript{16} Treas. Reg. § 1.6038A-2(b)(5)(i).
\textsuperscript{17} Treas. Reg. § 1.6038A-2(c).
\textsuperscript{18} Treas. Reg. § 1.6038A-2(b)(6).
\textsuperscript{19} Treas. Reg. § 1.6038A-3(b)(3).
\textsuperscript{20} Treas. Reg. § 1.6038A-3.
\textsuperscript{21} Treas. Reg. § 1.6038A-3(a)(1).
Safe Harbor Provisions

The record reporting requirement provides a safe harbor for record maintenance. Six broad types of records must be maintained:\(^22\)

1. Original entry books and transaction records
2. Profit and loss statements
3. Pricing documents
4. Foreign country and third-party filings
5. Ownership and capital structure records
6. Records of loans, services, and other nonsales transactions

The profit and loss category is complex. Profit and loss statements may be required on a consolidated basis, encompassing the U.S. reporting corporation and all related parties, including the foreign parent corporation and other affiliates.\(^23\) As part of these computations, a taxpayer may need to ascertain gross revenues and return on assets for both product lines and models to determine material industry segments.\(^24\) Each of the six categories contains numerous sub-categories, and a choice of records may be made in some situations.\(^25\)

The profit and loss statement data must be computed under U.S. Generally Accepted Accounting Principles (GAAP), if records are maintained on this basis. In other situations, an explanation of the difference between U.S. GAAP and the foreign accounting principles must be explained and made available to the IRS.

PENALTIES

Companies with significant foreign ownership are subjected to extensive reporting obligations. A failure to furnish, maintain, or produce records and data can lead to monetary penalties. The penalty is $10,000 per year, which can be multiplied up to $120,000 if the IRS notifies that taxpayer.\(^26\) Separate penalties under Form 5472 could be imposed for each foreign related party, including brother-sister corporations.\(^27\)

MANDATORY AGENCY AGREEMENTS

The IRS has sought to examine the books and witnesses of foreign related parties, but its attempts have often been thwarted. In response, the statute has sought to

\(^{22}\) Treas. Reg. § 1.6038A-3(c).
\(^{23}\) Treas. Reg. § 1.6038A-3(c)(2)(ii).
\(^{24}\) Treas. Reg. § 1.6038A-3(c)(5).
\(^{25}\) Treas. Reg. § 1.6038A-3(c)(2).
\(^{26}\) Treas. Reg. § 1.6038A-4(a)(1).
\(^{27}\) Treas. Reg. § 1.6038A-4(d).
invoke mandatory agency agreements between the U.S. subsidiary and its foreign related parties. The regulations implement this provision by providing agency authorization by the foreign party.28

When this agency relationship is requested by the IRS, intercompany costs and expenses might be disallowed by the IRS29 if the foreign related party and the U.S. subsidiary do not sign this agency agreement. In this regard, the regulations treat the failure to authorize the agency agreement as an act of noncompliance.30

The agency provisions would enable the IRS to have access to the books and records of the foreign affiliate. As a result, the IRS could determine the income and costs of each party in the group.

Concern was expressed that participation in this agency agreement might constitute a permanent establishment on the part of the foreign party. To alleviate this concern, the law stipulates that this agency agreement, without other activities, is not sufficient to constitute a permanent establishment of a fixed base for income tax purposes. Because the failure to establish an agency relationship has serious consequences, the regulations contain ameliorative provisions.31

**SUMMONS PROCEDURE**

A reporting corporation and its foreign related parties might receive an IRS summons requesting their records. If they fail to comply with this request, the IRS may then deny deductions that pertain to these intercompany transactions. The taxpayer has a heavier than normal burden of proof in seeking judicial review: Clear and convincing evidence is needed to show that the IRS determination has an improper motive or is clearly erroneous based on reasonably credible interpretations or assumptions of the facts.

**CONCLUSION**

The foreign reporting provisions of Section 6038A and the transfer pricing provisions of Section 482 are two of the most important weapons in the IRS’s arsenal. Both provisions apply independently; a taxpayer could run afoul of the foreign reporting rules without triggering a pricing adjustment, whereas pricing adjustments that take place separately are not necessarily subject to the foreign reporting provisions.

Both tax provisions are sometimes likened to a quiver with two arrows, but these two provisions are quite distinct because one operates separately from the other. In essence, the provisions create their own “audiences” of potential taxpayers.

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The filing of Form 5472 by a reporting corporation may trigger a tax audit; however, a failure by the reporting corporation to file Form 5472, when such filing is needed, is likely to exacerbate potential penalties on the part of the reporting corporation. Once the audit of a company is underway, whether or not the filing of Form 5472 triggered the audit itself, the review of Form 5472 by the IRS auditor may lead to the issuance of information document requests to the reporting corporation. An audit of Form 5472 for a specific company should enable the IRS to review the information provided in a relatively expeditious manner. As a result, this Form 5472 procedure enables the IRS to address a high percentage of potential foreign reporting issues.

In contrast, transfer pricing issues are arrived at later and often arise sporadically during the audit process. A primary role of the foreign reporting provisions is to provide a database that will enable the IRS to ascertain the character and scope of foreign investment and the ensuing dividends, as well as to access the transfer pricing methodology. A baseball analogy that describes the process is a pitcher (the reporting provisions) and the catcher (the transfer pricing provisions) both trying to catch the ball (the taxpayer). A coordinated approach to tax audits by the IRS could leave the taxpayer between a rock and a hard place.

Foreign reporting issues could be reviewed relatively quickly by the IRS, and matters of contention between the IRS and the taxpayer could quickly be identified—and sometimes resolved in a timely manner. In contrast, pricing disagreements are more likely to lead to litigation.
The Organization for Economic Cooperation and Development (OECD), an international organization whose member countries include the United States and most industrialized countries, has recommended to its member countries that their tax administrations follow the guidance contained in the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and National Tax Administrations. Like the U.S. transfer pricing regulations, the OECD Guidelines adhere to the arm’s-length standard and recommend the use of uncontrolled comparable transactions and specific transfer pricing methods to determine a range of arm’s-length prices for a controlled cross-border transaction. While the Guidelines acknowledge that taxpayers should base their controlled transfer prices on a sound analysis and should document the basis on which such prices are set, the amount of effort called for by the Guidelines is markedly less than what U.S. regulations would require to avoid a tax penalty on a large transfer pricing adjustment.

Multinational enterprises and their advisors cannot afford to ignore the OECD Transfer Pricing Guidelines. Most OECD member countries, including major international traders such as the United Kingdom, have never issued detailed transfer pricing regulations. In those countries, the Guidelines may serve as de facto local transfer pricing regulations. Even when a member country has issued detailed regulations, the Guidelines will serve as the common point of reference for negotiations with the competent authorities of tax treaty partners over the proper allocation of taxable income from cross-border transactions. The impact of the OECD Guidelines is not limited to OECD member countries; the OECD has a program that encourages non-member countries to adhere to the Guidelines.

The official position of the United States is that its transfer pricing regulations are consistent with the OECD Guidelines. While that is true in general, in important particulars there appear to be differences. Some OECD member countries feel quite strongly that the U.S. regulations depart from the Guidelines, to the point where
multinational taxpayers risk antagonizing the tax administrators of certain countries when they advance what appears to be a U.S. transfer pricing approach. These differences between the approaches of different countries require multinational taxpayers to account for multiple and sometimes disparate rules when setting, documenting, and defending cross-border transfer prices. Because all OECD member countries profess adherence to the OECD Guidelines, express compliance with the Guidelines is the safest starting point from which to arrive at a defensible global transfer pricing policy.

Because most readers of this book will be familiar with the U.S. transfer pricing regulations, this chapter’s analysis of the OECD Guidelines will rely substantially on comparisons and contrasts with U.S. rules.

HISTORY

The OECD was founded in 1960. Its members today are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Korea, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. The OECD is governed by a Council of member representatives. The work of the OECD is mostly accomplished by committees of member country representatives, and the OECD’s “main tax policy body” is the Committee on Fiscal Affairs. Technically, the OECD Transfer Pricing Guidelines are a report of the Committee on Fiscal Affairs that has been approved for publication by the Council.

The present Guidelines are a successor to a 1979 report of the Committee on Fiscal Affairs entitled “Transfer Pricing and Multinational Enterprises.” Between the publication of the 1979 report and the publication of the present Guidelines, the Committee issued three other reports that addressed transfer pricing issues: a 1984 report entitled “Transfer Pricing and Multinational Enterprises—Three Taxation Issues,” a 1987 report entitled “Thin Capitalization,” and a 1993 report on the then-proposed U.S. transfer pricing regulations entitled “Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations.” According to the Committee on Fiscal Affairs, the current Guidelines are “intended to be a revision and compilation” of the 1979, 1984, and 1987 reports, which “also draw upon” the 1993 report.

Before the current Guidelines were approved by the Committee on Fiscal Affairs, discussion drafts were released in two parts and public comments were solicited. Part I, covering transfer pricing principles and methods, was released on July 8, 1994. Part II, covering special considerations for intangible property, services, cost contri-

3 Tax Management, 3 Transfer Pricing Report 290 (Jul. 20, 1994).
distribution (i.e., cost sharing) arrangements, administration, and documentation was released in March 1995.\(^4\) Because the current Guidelines now contain a chapter on each of the subjects, the discussion drafts have only a historical interest.

The Committee on Fiscal Affairs contemplates the eventual publication of chapters on transfer pricing issues involving permanent establishments and thin capitalization.\(^5\) In the expectation of additional chapters, the Guidelines have been published in looseleaf form.\(^6\)

**ACCESS TO THE GUIDELINES**

The Guidelines were published in English and in French, and the Council resolution approving their publication contemplates that member countries may translate them into other languages.\(^7\) Translations into German and Dutch are reportedly under consideration.\(^8\)

Because the Guidelines are copyrighted by the OECD, they are not published in any of the tax services or periodicals to which U.S. tax practitioners ordinarily have resort. The Guidelines can be purchased in the United States by calling the OECD Publications office at (202) 785-6323. Publication of a pocket-size version is reportedly under consideration.\(^9\)

**ORGANIZATION OF THE GUIDELINES**

The current edition of the Guidelines has a preface, a glossary, eight chapters, and an appendix. The preface provides a history of the process that led to publication of the Guidelines. The preface declares that member countries are “encouraged” to follow the Guidelines,\(^10\) a reminder that the Guidelines are not binding upon the OECD member countries, even though the Guidelines were approved by all of their representatives on the Council and the Committee on Fiscal Affairs. Reflecting the controversy surrounding the use of net profits methods to determine arm’s-length prices, the preface also declares that the Committee on Fiscal Affairs will review the use by member and nonmember countries of different various transfer pricing methods, net profits methods in particular, and that this review could lead to the publication of supplementary guidelines.\(^11\)

\(^4\) Tax Management, 3 Transfer Pricing Report 784 (Mar. 15, 1995).
\(^5\) Guidelines, Preface, ¶ 19.
\(^6\) Id.
\(^7\) Guidelines, Appendix Recommendation 1.2.
\(^9\) Id., at G-2.
\(^10\) Guidelines, Preface, ¶ 16.
\(^11\) Id., ¶ 19.
General Approach

The guidance contained in the Guidelines is divided among the following six chapters:

- **Chapter I:** The Arm’s-Length Principle
- **Chapter II:** Traditional Transaction Methods
- **Chapter III:** Other Methods
- **Chapter IV:** Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes
- **Chapter V:** Documentation
- **Chapter VI:** Special Considerations for Intangible Property
- **Chapter VII:** Special Considerations for Intra-Group Services
- **Chapter VIII:** Cost Contribution Arrangements

Chapters I–V were adopted by the Committee on Fiscal Affairs on June 27, 1995, and were approved by the Council for publication on July 31, 1995. Chapters VI–VII were adopted by the Committee on January 23, 1996, and were approved by the Council for publication in March 1996. Notably, the chapter on transfer pricing of services, Chapter VI, was published in advance of the pending revision of the U.S. transfer pricing rules for services. Chapter VIII was adopted by the Committee on Fiscal Affairs in June 1997 and was approved by the Council for Publication on October 1, 1997. The United States updated its own rules in December 1995.\(^\text{12}\)

Specific Analysis


DEFINITIONS

The glossary, which falls between the preface and Chapter I, defines more than 30 transfer pricing terms that are used throughout the Guidelines. For the most part, the Guidelines use the same terms that are used in the U.S. transfer pricing regulations and assign them the same meaning. Examples are “Advance Pricing Agreement,” “comparability,” and “set-off.” Although the glossary distinguishes between “controlled” and “uncontrolled transactions” in the same way as the U.S. regulations, the glossary refers to “enterprises” where the U.S. regulations would refer to taxpayers. The glossary uses the term “associated enterprise” where the U.S. regulations would refer to a “controlled taxpayer.”

With one exception, the glossary in the Guidelines use the same words as the U.S. regulations to define the transfer pricing methods recognized by both: comparable uncontrolled price (CUP), resale price, cost plus, and profit split. The exception, once again reflecting the controversy over net profits methods, is the “transactional net margin method,” a Guidelines term that corresponds to the term “comparable profits method” in the U.S. regulations. The Guidelines employ different terms to describe the collateral adjustments that may result from a primary adjustment to a taxpayer’s controlled transfer prices. Specifically, the terms “corresponding adjustment” and “secondary adjustment” in the Guidelines have the same meaning as the terms “correlative adjustment” and “conforming adjustment” in the U.S. regulations.

ARM’S-LENGTH STANDARD

A principal purpose of the Guidelines is to endorse continued application of the arm’s-length standard in determining whether the results of cross-border transfer pricing should be adjusted by national tax administrations. According to the Guidelines, the arm’s-length standard permits adjustments only insofar as the conditions that obtain between associated enterprises differ from those that would have obtained “between independent enterprises in comparable transactions and comparable circumstances.” The Guidelines cite Article 9 of the OECD Model Tax Convention as authority for this principle.

Departure from Arm’s Length

The Guidelines identify certain administrative practices as departures from the arm’s-length principle and recommend against their use. A comparison of controlled and uncontrolled transactions requires a consideration of all of the differences that might have affected the price charged in the uncontrolled transactions. Accordingly, the use of “unadjusted industry averages” to adjust the results of controlled transactions is expressly criticized. Restructuring a transaction into something other than what the

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14 Id.
15 Id., at ¶ 1.16.
associated enterprises actually undertook is described as an arbitrary and inequitable exercise unless either of two situations apply: (1) the substance of the transaction varies from its form, or (2) the form varies so far from what uncontrolled enterprises would have undertaken that it impedes the determination of an arm’s-length price.16

**Global Formulary Apportionment**

The use of “global formulary apportionment” is singled out for special condemnation by the Guidelines. It is described as the allocation of global profits among associated enterprises on the basis of a “predetermined and mechanistic formula,” such as an allocation in proportion to assets, sales, or the like.17 This element of the Guidelines opposes, in effect, a campaign by U.S. Senator Byron Dorgan, a former state tax commissioner, to require the IRS to consider using formulary apportionment in the cross-border context.

The Guidelines object to the use of mechanical formulas, not the use of ratios per se. The Guidelines acknowledge that the transactional net margin method and profit split method may allocate profits in proportion to sales or assets, however, the proportion used under those methods is not a predetermined fraction—it is the proportion of profits to sales or assets actually observed in specific uncontrolled transactions.18 The Guidelines also acknowledge that, when other methods cannot readily be applied, a taxpayer and the national tax administration may agree on a proportional apportionment formula geared to that taxpayer’s facts and circumstances.19 For example, for several years, the IRS has been negotiating advance pricing agreements that use proportional apportionment formulas to allocate profit from “global trading” in financial products.20

**COMPARABILITY**

The Guidelines hold that the results of uncontrolled transactions can serve as a useful benchmark for adjusting the results of controlled transactions only if the “economically relevant characteristics” of the controlled and uncontrolled transactions are “comparable.”21 For this purpose transactions are considered to be comparable only if (1) any differences would have no material effect on the results, or (2) any material effect can be eliminated by adjustments.22 The attributes of a transaction that may affect comparability are the following:

- The specific characteristics of the product or service being sold
- The functions performed by the parties

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16 Id., at ¶ 1.37.
17 Id., Chap. III, ¶ 3.59.
18 Id., at ¶ 3.60.
19 Id.
21 Guidelines, Chap. I, ¶ 1.15.
22 Id.
Any contractual terms
- The economic circumstances of the parties
- The business strategies of the parties

These attributes are essentially the same as the factors identified by the U.S. transfer pricing regulations as relevant to comparability. One purely formal distinction between the Guidelines and Regulations is that the U.S. regulations treat the risks assumed by the parties as a separate factor, whereas the Guidelines treat risk as part of the functional analysis.

Regarding contractual terms, the Guidelines mirror the U.S. regulations in cautioning that substance may vary from form in a controlled transaction and that the national tax administration should analyze comparability based upon the true terms of the transaction. Among the relevant “economic circumstances” listed in the Guidelines are the levels (wholesale vs. retail) and geographic location of the markets in which the controlled and uncontrolled transactions take place, factors also emphasized in the U.S. regulations. Among the relevant “business strategies” listed in the Guidelines are “market penetration schemes,” whereby a taxpayer may charge lower prices than uncontrolled enterprises in order to enter or expand into a new market. Like the U.S. transfer pricing regulations, the Guidelines affirm that lower prices do not warrant an adjustment if the market penetration strategy is plausible and reasonably limited in time.

**ARM’S-LENGTH RANGE**

Like the U.S. transfer pricing regulations, the Guidelines specify that a range of prices or profit results may qualify as arm’s length. The Guidelines observe that a range may be particularly appropriate when the transactional net margin method is applied. The Guidelines state that substantial deviations within the range may reflect variations in the reliability of data supporting the various points within the range. By contrast, the U.S. regulations suggest that such deviations may reflect a lack of complete comparability. The Guidelines do not follow the U.S. approach of adjusting for suspiciously wide ranges by applying statistical methods such as the interquartile range. Less helpfully, the Guidelines simply propose “further analysis.” Moreover, while the U.S. regulations provide that controlled transactions that
fall without the arm’s-length range will ordinarily be adjusted to the midpoint of the range, the Guidelines simply note that there are arguments both for adjusting to the midpoint and for adjusting to the nearest endpoint.\footnote{Id., at ¶ 1.48.}

\section*{TRANSFER PRICING METHODS}

The Guidelines recognize five transfer pricing methods as potentially consistent with the arm’s-length principle: the CUP method, the resale price method, the cost-plus method, the profit split method, and the transactional net margin method. The first three are described as “traditional transaction methods.”\footnote{Guidelines, Chap. II, ¶ 2.1.} They are applied by the Guidelines in much the same way as their namesakes in the U.S. regulations. The transactional net margin method corresponds to the comparable profits method of the U.S. regulations, while the profit split method corresponds to the method of the same name in the U.S. regulations.

\subsection*{Transactional Profits Methods}

The Guidelines distinguish the profit split and transactional net margin methods from the traditional transaction methods by referring to them as “transactional profits methods.”\footnote{Id., Chap. III, ¶ 3.1.} This distinction is somewhat misleading. The resale price and cost-plus methods are also profits methods, because the resale price margin and cost-plus markup on which those methods depend ordinarily equate to the gross profits from the transactions being compared. The real distinction is that the transactional profits methods ordinarily focus on net rather than gross profits.\footnote{Id., at ¶¶ 3.17, 3.26.}

The traditional transaction methods are the three methods that were specifically endorsed in the 1968 U.S. transfer pricing regulations. Under those regulations, other methods were to be applied only if the traditional methods could not be used. This priority of methods was abandoned in the current U.S. regulations, but it is preserved in the Guidelines, which describe the profit split and transactional net margin method as methods “of last resort” to be applied only when “practical difficulties” impede application of the traditional transaction methods.\footnote{Guidelines, Chap. II, ¶ 2.49; Chap. III, ¶ 3.1.}

The inclusion of the word \textit{transactional} in the phrase “transactional profits method” is purposeful. The Guidelines emphasize that the methods are applied to “particular controlled transactions” out of concern that the methods might otherwise be applied on the basis of aggregate financial data of controlled and uncontrolled enterprises without sufficient regard to differences that may exist between their actual transactions.\footnote{Id., at ¶¶ 3.2, 3.53.}
Net Profits Method

The Guidelines were drafted after the United States had issued proposed regulations that seemed to require that the profitability of enterprises engaged in controlled transactions be tested using a net profits method in addition to any other methods employed. Although the final version of the U.S. regulations treated net profits methods as simply alternatives to be used when they happen to be more reliable than other recognized methods, the generally unfavorable response of most OECD tax administrations to the proposed U.S. regulations colored the drafting of the Guidelines. Acknowledgment of the transactional net margin method as consistent with the arm’s-length principle represented a victory of sorts for the U.S. point of view, but the acceptance of net profits methods in the Guidelines is so hedged about with cautions that the issue could fairly be said to remain unresolved.

The Guidelines note that most countries prefer the profit split over the transactional net margin method, assuming they recognize the latter method at all. One important reason is that the profit split method looks at both parties to the transaction and is therefore less likely to yield an extreme result for either party. By contrast, the transactional net margin method, which looks at only one side of the transaction, may result in dramatically different profit results for members of a group that, as a group, has unusually high or low profits.

Some critics of the U.S. comparable profits method claim that it is favored by the IRS precisely because it ordinarily attributes profits to U.S. subsidiaries of foreign-controlled groups, regardless of the group’s global profitability. For example, during the early 1990s, many Japanese multinationals were unprofitable on a globally consolidated basis, but their U.S. subsidiaries were subject to U.S. transfer pricing adjustments that made them profitable for U.S. tax purposes. Competent authority negotiations between the United States and Japan came to a standstill when the United States held as firmly to the comparable profits method as did the Japanese to the profit split method. In at least one case the deadlock was broken by the application of a hybrid profit split method that combined elements of both methods.

Comparable Uncontrolled Price Method

The CUP method compares the price charged for controlled transfers to the price charged for comparable uncontrolled transfers. When comparable uncontrolled transactions can be identified, it is “preferable over all other methods.” The Guidelines apply the CUP method to tangible property, intangible property, and services. Under the U.S. regulations, the CUP method applies only to transfers of tangible property. The regulations provide an analogous method for transfers of intangible

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39 Id., at ¶ 3.52.
40 Id., at ¶ 3.7.
41 Id., at ¶ 3.31.
42 Id., Chap. II, ¶ 2.6.
43 Id., at ¶ 2.7.
44 Id., Chap. II at ¶ 2.11, Chap. VI at ¶ 6.23, Chap. VII at ¶ 7.31.
property called the comparable uncontrolled transaction (CUT) method. The U.S. regulations presently contain no analog to the CUP method for services. That may change when the pending overhaul of the services regulations is completed.

**Resale Price Method**

The resale price method determines an arm’s-length price for an enterprise’s controlled purchases of property by subtracting from the uncontrolled resale price an appropriate gross margin (the “resale price margin”). The appropriate resale price margin can be determined from uncontrolled purchases and resales by the enterprise or from uncontrolled purchases and resales by independent enterprises. The Guidelines note that the activities of a reseller may range from a mere forwarding function to full ownership of the inventory and full responsibility for a variety of connected services, such as advertising and guaranteeing the products, and that the level of activity will influence the size of the appropriate margin.

The resale price method tolerates larger differences between the products sold in controlled and uncontrolled transactions than does the CUP method, and greater weight may be given to functional comparability. The method may be difficult to apply when the reseller adds substantially to the value of the product. The Guidelines contemplate using the resale price method for both tangible and intangible property, the latter when the property is sublicensed to third parties. By contrast, the U.S. regulations contemplate its use only for tangible property.

**Cost-Plus Method**

The cost-plus method determines the arm’s-length price for a controlled sale by adding an appropriate markup to the costs incurred by the seller. The appropriate markup is ideally determined from uncontrolled sales by the enterprise, but markups realized by independent suppliers can also be used. As with the resale price method, product comparability is generally less critical than functional comparability. Although the U.S. regulations limit the cost-plus method to sales of tangible property, the Guidelines also contemplate its use for the sale of services. Consistent with the aversion of the Guidelines to the use of net profits methods, adjustments for differences in expenses are allowed if they reflect functional differences, but not if they reflect only different efficiency.
Profit Split Method

The profit split method determines the division of profits from controlled transactions in accordance with how profits would have been divided between independent enterprises. What the Guidelines refer to as “contributions analysis” allocates profit in accordance with the relative value of the functions performed by the parties. What the Guidelines refer to as “residual analysis” first assigns a basic market return to each party and then divides the residual profits, presumably attributable to unique and valuable assets based upon an analysis of the facts and circumstances.

The distinction in the Guidelines between contribution and residual analysis corresponds roughly to the distinction in the U.S. regulations between comparable and residual profit splits; however, although the division of profits between comparably situated independent parties is only one factor that may be considered in applying “contribution analysis” under the Guidelines, it is the essential factor for using the “comparable profit split” method under the U.S. regulations.

Transactional Net Margin Method

The transactional net margin method compares the net profit margins from controlled and uncontrolled transactions relative to an appropriate base such as sales, costs, or assets. Like the cost-plus method, it is ideally applied to controlled and uncontrolled transactions of the tested enterprise but can also be applied using the margins on comparable transactions of an independent enterprise. Like the U.S. regulations, the Guidelines state that this method is less adversely affected by differences in products than is the CUP method and less adversely affected by differences in functions performed than are the resale price and cost-plus methods.

The principal distinction between the transactional net margin method of the Guidelines and the comparable profits method of the U.S. regulations is their approach to aggregation of financial data about controlled and uncontrolled transactions. The comparable profits method requires that the analysis be based on the “most narrowly identifiable business activity” for which financial data is available. By contrast, the Guidelines start from the presumption that transactions are ideally analyzed individually and that each level of aggregation must be justified. Critics of the comparable profits method in some OECD countries are concerned that “the most narrowly identifiable business activity” may exceed the degree of aggregation that would be acceptable under the Guidelines.

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56 Id., at ¶ 3.5.
57 Id., at ¶¶ 3.17, 3.19.
58 Id., at ¶ 3.26.
59 Id.
60 Id., at ¶¶ 3.27, 3.34.
61 M. Taly, Comparison of CPM and TNMM Transfer Pricing Methods: A Point of View, Tax Notes International 351 (Jan. 29, 1996).
TRANSFER PRICING ADMINISTRATION

Chapter IV of the Guidelines deals with administrative approaches to resolving transfer pricing disputes that may arise between multinational taxpayers and local tax authorities.

Examinations

The Guidelines encourage national tax administrations to take the commercial judgment of taxpayers into account when analyzing their transfer prices and, in particular, to commence their analysis from the perspective of the method used by the taxpayer to set controlled transfer prices.62 Article 26 of the OECD Model Tax Convention provides for exchange of information between competent authorities of treaty countries, and the Guidelines assert that Article 26 is sufficient authority for the conduct of simultaneous transfer pricing examinations.63 Simultaneous examination procedures are customarily embodied in working arrangements between the tax authorities,64 and the OECD has drafted and recommended to its members a “Model Agreement for the Undertaking of Simultaneous Tax Examinations.”65

Mutual Agreement Procedure

Article 25 of the OECD Model Tax Convention provides for the resolution of tax treaty disputes through a “mutual agreement” procedure involving the “competent authorities” of the treaty countries. As the Guidelines note, the competent authorities must endeavor to reach an agreement, but are not compelled to do so.66 The Guidelines assert that in competent authority proceedings, the state that initiated a transfer pricing adjustment bears the burden of demonstrating to the other state that the adjustment was correct.67

Corresponding, Compensating, and Secondary Adjustments

Article 9 of the OECD Model Tax Convention provides that a treaty state “shall” make a “corresponding adjustment” to the taxable income of a local enterprise when another treaty state has adjusted the taxable income of a related enterprise in that other state. Notwithstanding the word shall, the Guidelines observe that the corresponding adjustment is not mandatory and should not be made unless the treaty state considers the primary adjustment to be justified.68 The Guidelines note that corre-

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62 Guidelines, Chap. IV, ¶ 4.9.
63 Id., at ¶ 4.81.
64 Id., at ¶ 4.80.
65 Id., at ¶¶ 4.79, 4.92.
66 Id., at ¶ 4.31.
67 Id., at ¶ 4.17.
68 Id., at ¶ 4.35.
sponding adjustment relief is most commonly granted by recalculating the profits and tax of the local enterprise, but that it can also be provided through a credit against local tax for the increased tax attributable to the primary adjustment.69

U.S. regulations permit taxpayers to report taxable income on the basis of arm’s-length prices when those prices vary from the prices actually charged for controlled transactions of the taxpayer. The Guidelines refer to this practice as a “compensating adjustment.”70 While not rejecting the practice, the Guidelines note that most OECD countries do not permit such adjustments and that Article 9 “corresponding adjustment” relief may be inapplicable in such cases.71

The Guidelines use the term secondary adjustments to describe a constructive dividend or other constructive transaction that is asserted on the basis of a primary adjustment to account for the difference between booked and redetermined profits.72 The secondary adjustment may create additional tax, such as a withholding tax on a constructive dividend, or yet another adjustment, such as the imputation of interest on a constructive loan.73 The Guidelines observe that many countries do not make secondary adjustments and that Article 9 does not require that such adjustments be offset by corresponding adjustments.74 The Guidelines observe further that some countries that permit secondary adjustments allow taxpayers the alternative of repatriating excess profits or setting up a corresponding receivable.75 The United States has allowed the alternative of setting up a receivable since 1965,76 and a major overhaul of the pertinent procedures will reportedly be issued during 1997.

Safe Harbors

The Guidelines discuss the advantages and disadvantages of transfer pricing safe harbors.77 Finding a preponderance of disadvantages, the Guidelines recommend against their use.78 Where they are allowed, the Guidelines caution that the taxpayer must bear the risk of double taxation where the safe harbor is incompatible with an arm’s-length result.79

Advance Pricing Agreements

The Guidelines discuss the use of unilateral and multilateral advance pricing agreements (APAs).80 They list several advantages and disadvantages to the use of APAs. Given the lack of significant experience in many OECD countries, the Guidelines

69 Id., at ¶ 4.34.
70 Id., at ¶ 4.38.
71 Id., at ¶ 4.39.
72 Id., at ¶ 4.67.
73 Id., at ¶¶ 4.67, 4.68.
74 Id., at ¶ 4.70.
75 Id., at ¶¶ 4.73, 4.75.
77 Guidelines, Chap. IV, ¶¶ 4.94–4.123.
78 Id., at ¶ 4.123.
79 Id., at ¶ 4.112.
80 Id., at ¶¶ 4.124–4.166.
defer making a final recommendation in favor of or against their usage. Given that an APA may cover a period of years, the Guidelines caution against agreement on particular results as opposed to specific methodologies and against the use of implausible predictions.

The Guidelines endorse the preference of most countries for multilateral over unilateral APAs and urge national tax administrations to advise each other whenever a unilateral procedure is initiated. Although bilateral APAs are not specifically mentioned in Article 25 of the OECD Model Tax Convention, which relates to mutual agreement procedures, the Guidelines consider them to be within the Article’s scope. Consequently, countries with treaty provisions modeled on Article 25 have the authority to participate in bilateral APAs, even if domestic law does not provide for them.

**Arbitration**

Article 25 of the OECD Model Tax Convention, relating to mutual agreement procedures, does not provide for arbitration of transfer pricing or other treaty disputes, but the official Commentaries on Article 25 have mentioned arbitration as a possibility. The Guidelines contain only a brief discussion of transfer pricing arbitration. Taking note of an arbitration convention recently concluded within the European Community and other similar developments, the Guidelines declare that the Committee on Fiscal Affairs will undertake a study of arbitration and supplement the Guidelines with its conclusions thereof.

**DOCUMENTATION**

The Guidelines devote an entire chapter to the subject of documentation and advocate an approach that sharply contrasts with U.S. requirements in several particulars. Like the U.S. transfer pricing penalty regulations, the Guidelines hold that taxpayers should price controlled transactions in accordance with the arm’s-length principle and should document their efforts in case the prices are examined. The Guidelines note that the documentation obligations of a taxpayer depend in part upon where the burden of proof rests under domestic tax law, but conclude that even where the burden rests upon the tax administration, the taxpayer may be obligated to produce...
sufficient documentation to permit an examination of the taxpayer’s transfer prices.91

Production

The Guidelines recommend against requiring production of documents that became available only after the controlled transaction took place.92 This sharply contrasts with U.S. transfer pricing penalty regulations, which require taxpayers to document all transfer pricing information that becomes available until the return is filed. While the IRS National Office has stated that IRS policy is not to request transfer pricing documentation for a year later than the year under examination, examiners have reportedly asked for such documents in some cases.

A premise of the documentation recommendations of the Guidelines is that taxpayers are not expected to take account of information that becomes available only after a controlled transaction has occurred.93 U.S. regulations, in contrast, penalize taxpayers that fail to report arm’s-length results because they did not consider and document all information available through the end of the taxable year.

Disclosure

The Guidelines recommend against requiring production of transfer pricing documents when the return is filed beyond the minimum necessary to identify taxpayers needing examination.94 An example of this would be a requirement to disclose on the return which transfer pricing methods were used by the taxpayer. Some OECD countries, such as Australia and Canada, have enacted such requirements. Proposed U.S. penalty regulations would have required disclosure of profit split methods and methods not specified in the transfer pricing regulations, but this requirement was dropped in the final regulations.

The Committee on Fiscal Affairs intends to continue studying the subject of documentation in order to provide additional guidance in the future.95

INTANGIBLE PROPERTY

The Guidelines include a separate chapter on special considerations for the transfer pricing of intangible property.96

Definitions

The Guidelines include within the term *intangible property* rights to use industrial assets (e.g., patents, trademarks, trade names, designs, and models), literary and

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91 Id., at ¶ 5.2.
92 Id., at ¶ 5.8.
93 Id., at ¶¶ 5.3, 5.28.
94 Id., at ¶ 5.11.
95 Id., at ¶ 5.29.
96 Guidelines, Chap. VI.
artistic rights, and other intellectual property (e.g., know-how and trade secrets). What distinguishes intellectual property from other intangible assets is that it cannot be registered for protection. It is noted that intangible assets may have considerable value even though no value is booked on the enterprise’s balance sheet; however, the Guidelines also caution that not all research and development and marketing expenditures will result in the production of intangible property. For example, marketing expenditures are considered to create intangible property only if they have significant impact beyond the year in which they are incurred.

The Guidelines distinguish between *marketing intangibles*, such as trademarks and trade names, and other commercial intangibles that it refers to as *trade intangibles*. Trade intangibles are associated with production and often are created through risky and costly research and development. The Guidelines note that the distinction between income from trade and marketing intangibles may not be clear cut when a branded product is sold, and that a single price may cover the value of the goods and of related intangibles. The Guidelines also discuss the special difficulty of discerning the appropriate return on marketing expenses of a distributor, reasoning that the distributor is generally entitled only to reimbursement of its costs plus an agency fee unless the expenses create a marketing intangible in which the distributor enjoys long-term rights.

**Limitation**

As the Guidelines observe, the uniqueness of many intangible assets makes it difficult to establish transfer prices based on comparable uncontrolled transactions. Tax administrations are advised to take special account of whether an intangible asset has the same value and usefulness in the hands of the controlled licensee as it would have in the hands of an independent licensee. The valuation standard should be the actual value of the intangible to the licensee, not its highest or most productive use.

The Guidelines identify some special factors relevant to the transfer pricing of intangibles: expected benefits, geographic limitations on use, export restrictions, the degree of exclusivity, required investments and start-up costs, sublicensing possibilities, the licensee’s distribution network, and any right of the licensee to participate

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97 Id., at ¶ 6.2.
98 Id., at ¶ 6.3.
99 Id., at ¶ 6.2.
100 Id., at ¶ 6.6.
101 Id., at ¶ 6.7.
102 Id., at ¶ 6.3.
103 Id.
104 Id., at ¶¶ 6.12, 6.17.
105 Id., at ¶¶ 6.36–6.39.
106 Id., at ¶ 6.13.
108 Id., at ¶ 6.15.
in further development of the intangible.\textsuperscript{109} It is appropriate to take bids and offers of unrelated parties into account when pricing the intangible.\textsuperscript{110}

The CUP method may be employed when sufficiently comparable uncontrolled transactions are identified; the resale price method may be used when the intangible is sublicensed; and the profit split method may be acceptable in the case of highly valuable intangibles for which no comparable transactions can be identified.\textsuperscript{111} Where taxpayers have set intangible property prices based on reasonable expectations of future benefits, tax administrations should not adjust the prices based on variations in actual benefits, unless independent parties would not have entered into the arrangement without providing for such adjustments.\textsuperscript{112} This admonition appears to be directed at the U.S. requirement that payments for intangibles be commensurate with the income realized by the transferee, through periodic adjustments, where necessary.\textsuperscript{113}

\section*{SERVICES}

The Guidelines include a separate chapter on special considerations for intra-group services.\textsuperscript{114} The Guidelines note that a multinational enterprise must arrange for the provision of administrative, technical, financial, and commercial services to group members; that such services may be provided by members of the group or by independent enterprises; and that the initial cost may be absorbed by the parent, the members of the group, or by a designated member.\textsuperscript{115} The Guidelines observe that the transfer pricing of services is complicated because they are often \textit{rendered in connection with transfers of tangible and intangible property}.\textsuperscript{116}

The Guidelines identify two “major issues” in the analysis of transfer pricing for services: (1) whether services were actually provided, and (2) what constitutes an arm’s-length charge.\textsuperscript{117} In general a service should be regarded as provided only if it enhances the commercial position of the recipient so that the recipient would have been willing to pay for the service or perform it for itself.\textsuperscript{118} For example, no charge is ordinarily required for services that duplicate services that the recipient performs for itself or for services performed by a parent company solely because of its ownership interests, called “shareholder activity” in the Guidelines.\textsuperscript{119} Examples of \textit{share-
holder activity include acquisition fundraising, parent reporting (including consolidation of reports), and shareholder and board meetings.\footnote{Id., at ¶ 7.10.} Shareholder activity is distinguished from stewardship activity, such as planning and technical advice, which may commercially benefit associated enterprises.\footnote{Id., at ¶ 7.9.}

The Guidelines refer to the practice of charging for specific intragroup services as the direct-charge method and favor such arrangements when they are feasible.\footnote{Id., at ¶¶ 7.20, 7.21.} The Guidelines acknowledge that the impracticality of the direct-charge method will necessitate the use of allocation and apportionment methods, referred to in the Guidelines as indirect-charge methods.\footnote{Id., at ¶ 7.23.}

When determining an arm’s-length charge for intragroup services, the CUP method or the cost-plus method may be used.\footnote{Id., at ¶ 7.31.} When the service provided is not an ordinary or recurrent activity of the provider, the market value of the service may not greatly exceed the costs incurred, in which case no adjustment to create a profit is required under the CUP method, and the costs of providing the service may have to be adjusted in order to apply the cost-plus method.\footnote{Id., at ¶¶ 7.40, 7.41.} The Guidelines include some examples of intragroup services, noting that contract manufacturers and researchers that bear no financial risk are essentially service providers and that the cost-plus method may be appropriate in such cases.\footnote{Guidelines, Chap. VIII.}

**COST CONTRIBUTION ARRANGEMENT (CCA)**

The Guidelines include a separate chapter on the “cost contribution arrangement,”\footnote{Id., at ¶ 8.3.} which is defined as a “contractual arrangement” among business enterprises “to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights.”\footnote{Id. at ¶ 8.1.} Within the Guidelines, a cost contribution arrangement is referred to by its acronym “CCA.”\footnote{Treas. Reg. § 1.482-7(b)(4).}

Unlike the U.S. cost-sharing regulations,\footnote{Guidelines, ¶ 8.41.} the Guidelines do not expressly require that the CCA be in writing, although adequate documentation is encouraged.\footnote{Id., at ¶ 7.34, 7.35.} The Guidelines list seven “conditions” that should “normally” be met when structuring a CCA and a dozen items of information relating to the initial terms or

\footnote{Guidelines, Chap. VIII.}
subsequent progress of the arrangement that a taxpayer “should” be prepared to provide upon request.  

Under a CCA, each enterprise’s contribution to costs should be in proportion to its expected share of the benefits. The tax classification of the contributions (e.g., whether they are deducted or capitalized) is ordinarily no different than if the payments were made outside of a CCA. If there are contributions in kind, they must be valued in order to determine whether proportionality exists. Special payments made among the participants to satisfy the requirement for proportionality are referred to as “balancing payments”, which are generally treated as a reduction in the cost contribution of the payee. If the tax authority determines that contributions are not proportional to expected benefits, the typical adjustment will be imputation of a balancing payment.  

A participant that joins a CCA after development has already commenced should make a “buy-in” payment that reflects the expected benefit to the participant. Because the evaluation of expected benefits will change as development progresses, a buy-in payment may be substantially more or substantially less than a pro rata share of the prior contributions. 

Expected benefits may be in the form of increased income or decreased costs. A technique for measuring expected benefits that the guidelines acknowledge and appear to endorse is the use of “allocation keys” such as “sales, units used, produced, or sold, gross or operating profit, the number of employees, capital invested, and so forth.” The Guidelines acknowledge that transfer pricing is “not an exact science” and, implicitly, that the allocation of actual benefits may vary significantly from what was reasonably expected; however, if the variance is so great that it conflicts with “commercial reality,” the tax authority may impute an obligation of the disproportionately benefited participant to compensate the others. 

A CCA treats the parties as “effective owners” of the property that is developed, so that no party is obligated to pay for the use of the developed property beyond its contribution to the cost of development. Historically, CCAs, or (as they are perhaps more commonly known) cost-sharing arrangements, were especially useful for handling the tax consequences of developing property that was not susceptible to legal ownership. Where there is legal ownership, normal transfer pricing principles

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132 Id. at ¶ 8.41-8.43.  
133 Id. at ¶ 8.3.  
134 Id. at ¶ 8.23.  
135 Id. at ¶ 8.16.  
136 Id. at ¶ 8.18.  
137 Id. at ¶ 8.25.  
138 Id. at ¶ 8.26.  
139 Id. at ¶ 8.31.  
140 Id. at ¶ 8.19.  
141 Id.  
142 Id. at ¶ 8.3.  
143 Id. at ¶ 8.30.  
144 Id. at ¶ 8.3.
would regard development payments by an enterprise that did not have legal title as contributions to the owner, which might be construed for tax purposes as a dividend (if the payor was a subsidiary of the owner of the property) or a capital contribution (if the payor was the parent of the owner of the property); however, the Guidelines make clear that the allocations of interests under a CCA that satisfies the arm’s-length standard will be respected even if those interests do not correspond to rights of legal ownership.145

145 Id. at ¶ 8.4.
The transactional net margin method (TNMM) is a transfer pricing methodology adopted by the Organization for Economic Cooperation and Development (OECD) in 1995. This method is included in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published by the OECD.

The TNMM, like the comparable profits method (CPM), approximates arm’s-length conditions when traditional transaction methods cannot be reliably applied alone or in exceptional circumstances when these traditional methods cannot be applied at all.1

Several questions arise as a result of the OECD’s adoption of TNMM, including:

- Are there substantial differences between TNMM and CPM?
- How is TNMM applied in real-world situations?
- What are the strengths and weaknesses of TNMM?

This chapter provides our initial answers to these questions.

**INTRODUCTION TO TRANSACTIONAL NET MARGIN METHOD**

The TNMM examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction.2 TNMM is based on the concept that returns earned by firms operating in the same industry and under similar conditions tend toward equality over a reasonably long period of

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This is the definition used in the U.S. regulations. The points raised here apply equally to these and most other definitions of net profit.

time. This equality concept arises from economic theory and common sense. If one firm is earning higher returns than its rivals, it should be able to expand its production or sales at the expense of the less-efficient competitors. In the long run the firm’s competitors will either go out of business or become more efficient, and thus increase their returns. Economic theory predicts what will happen in equilibrium over the long run but is silent about the time needed to achieve equilibrium or what the rates of return ought to be in the interim. For example, the fact that companies as a group will earn a return on assets of 10 percent in the long run is not helpful in determining whether a business that earns a 15 percent return on assets this year has or has not set its intercompany prices on an arm’s-length basis. As discussed later, recognition of this timing issue is one of the strengths of the OECD Guidelines.

In TNMM, the profits earned by a taxpayer in a controlled transaction (or a group of transactions that can be aggregated under the principles of Chapter I of the Guidelines) are compared with the same measure of profitability from arm’s-length uncontrolled transactions. As the Guidelines state, “The net margin of the taxpayer from the controlled transaction . . . should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide.”3 The TNMM is based on the net profit margin that we assume to be operating profit or earnings before interest and taxes4, rather than the gross profit margin on which both the resale price and cost-plus methods are based. The net profits are expressed relative to sales, costs, or assets; the most commonly employed measures are return on sales and return on assets.

Only one party to the controlled transaction is analyzed in applying TNMM. The choice of which party to examine (the “tested” party in U.S. parlance) depends on the availability of comparable data. In general, TNMM is applied to the least complex entity involved in the intercompany transaction. There are usually more comparable data in existence for the least complex entities, and fewer adjustments will be required to account for differences in function and risk between the controlled and uncontrolled transactions. Substantial differences in intangible property ownership generally render a potential comparable unusable for TNMM, as well as for all other methods.

TNMM can be used to determine transfer prices at the time those prices are set (see the following example), or it can be used to test the reasonableness of transfer prices established by some other means. Tax authorities are likely to use TNMM as a test of reasonableness to determine whether a transfer pricing audit should be initiated. Before applying TNMM for this purpose, it is necessary to determine what profits will be analyzed. TNMM applies only to intercompany transactions, not to all transactions (including those with unrelated parties). If it were otherwise, the results would be distorted.

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4 This is the definition used in the U.S. regulations. The points raised here apply equally to these and most other definitions of net profit.
For example, assume that Company A is a distributor of products in Country B. Company A purchases Product X (accounting for 50 percent of its sales) from an unrelated party and Product Y (accounting for 50 percent of its sales) from A’s foreign parent. Products X and Y are similar in nature such that no adjustment is required for quality, design, or any other material item. Assume that the income statement for Company A is as follows:

<table>
<thead>
<tr>
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<th>Product X</th>
<th>Product Y</th>
<th>Combined</th>
</tr>
</thead>
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<td>Gross profit</td>
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<td>14</td>
</tr>
<tr>
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<td>4</td>
<td>8</td>
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</tbody>
</table>

Product X is purchased from an unrelated manufacturer. The transfer prices for Product Y are based on a transaction-based method that produced arm’s-length prices. Company A’s tax return is selected for potential audit in Country B. The tax authority in Country B uses TNMM to determine whether A’s transfer pricing should be audited. If the tax authority examines the tax return, it will see that the ratio of operating income to sales on a combined basis is 6 divided by 20, or 30 percent. This ratio focuses on the total profit of the enterprise, irrespective of whether the purchases are from a related party. Suppose that the Country B tax authority has determined that distributors in Country B should earn operating income/sales of 35 percent (7/20). In this case, the income statement, after adjustment by the Country B tax authority, would appear as follows:

<table>
<thead>
<tr>
<th></th>
<th>Product X</th>
<th>Product Y</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>10</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>4</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Gross profit</td>
<td>6</td>
<td>9</td>
<td>15</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>4</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>Operating income$^a$</td>
<td>2</td>
<td>5</td>
<td>7</td>
</tr>
</tbody>
</table>

$^a$Operating income is 35% of sales of $20.

Because the transactions involving Product X are with unrelated parties, no change can be made to those transactions. All changes must be made for Product Y. If the intercompany transaction were viewed separately as to Products X and Y, the tax authority would see that profitability in Company A relative to the intercompany purchases was “more than arm’s length” and no tax assessment was appropriate. By making the decision based on TNMM as applied to the combined related and unrelated transactions of Company A, the lack of profitability on the unrelated transactions is shifted to the parent company. The only appropriate application of TNMM, or any other profit-based method, is to the intercompany transactions, not to the total company results.
Applying the TNMM

The steps required to apply the TNMM include the following:

- Perform a functional analysis.
- Identify comparables.
- Choose a profit measure.
- Determine the appropriate time period for analysis.
- Test the reasonableness of results.

Detailed descriptions of these tasks are provided in this section. The section concludes with two examples demonstrating the implementation of TNMM.

Performing a Functional Analysis and Identifying Comparables

The first step in applying TNMM is to analyze the functions performed by the affiliate in question and the risks borne by that affiliate, and to determine whether the affiliate owns valuable intangible property.

The second step is to identify potentially comparable transactions or companies. The Guidelines recommend using internal comparables, which are uncontrolled transactions in which the affiliate participates, if possible. Transactions in which the taxpayer is not involved should be used only if there are no internal comparable transactions. The Guidelines approach is consistent with the Section 482 regulations. Companies have much more detailed information about transactions in which they participate than unrelated transactions in which they do not participate. As a result, the comparability of the transactions can be evaluated with more accuracy than when data are limited to publicly available information from third-party transactions. For example, in the illustration for Company A, it would be wise to determine whether the profitability on the resale of Product X (purchased from an unrelated company) could be used to determine transfer prices for Product Y.

A function and risk assessment should be performed once the comparables have been identified, whether the comparables are internally generated or the company is relying on external comparables. This function and risk analysis is necessarily less thorough for external comparables than for analysis of the affiliated party. Because the goal is to obtain the “correct” arm’s-length answer, great care must be taken to ensure that all differences that can affect profitability are identified and accounted for through adjustments to the comparables.

The Guidelines do not discuss adjustments for differences in functions and risks in much detail. Instead, they emphasize the need to carefully choose comparables that are as similar in function and product as is possible. “Where differences in characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences.”

\(^5\)Guidelines, B.3.53.
In applying CPM, some practitioners believe that selection of broadly similar companies does not require function and risk differences to be accounted for before determining the arm's-length range. CPM and TNMM are identical from the standpoint of adjustments to account for function and risk differences. In this case, the U.S. regulations require the use of the “interquartile range” for setting transfer prices. Other practitioners view function and risk adjustments as mandatory, if a true arm’s-length range is to be determined. If adjustments are made, the U.S. regulations allow the use of the entire range. We believe that adjustments must be made; if they are not, the interquartile range does not necessarily match the arm’s-length range.

After deciding what comparables are to be used, and whether to make adjustments for differences in functions and risks, it is necessary to choose a particular measure of profitability in applying TNMM. The OECD Guidelines are not very specific regarding the profit measures that can be employed. In general, it is a good idea to employ more than one profitability measure, using one to test the reasonableness of the others. Using this additional measure to test the selected method provides additional assurance that the transfer pricing is reasonable, assuming, of course, that the other method yields a result consistent with the original method chosen. Before illustrating the application of TNMM, we will discuss the advantages and disadvantages of the commonly used measures of profitability or profit-level indicators.

**Choosing Profit-Level Measures**

All of the profit-level measures used in TNMM are based on operating income, which is gross profit less operating expenses. Typically, return on assets (operating income/assets) or return on sales (operating income/net sales) are the two profit-level measures analyzed to determine transfer prices. Iterations on the return-on-assets theme include the following:

- Operating income/gross assets minus current liabilities
- Operating income/gross assets
- Operating income/assets minus liabilities

The OECD Guidelines state that “net margins . . . are less affected by transactional differences than is the case with price, as used in the CUP method.” The Guidelines go on to state, “The net margins also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.” In addition, the net margin may be less sensitive to differences in Generally Accepted Accounting Practices (GAAP) across countries (and companies within a country).

**Return on Assets** The return on assets measure is more firmly grounded in economic theory than the return on sales measure. Economic theory does not say that returns on sales should be equal in equilibrium, only that return on assets should be. Firms

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6Guidelines, B.3.27.
grow or decline by gaining or losing capital investment. Investors invest capital in companies that are particularly profitable and disinvest in less profitable companies. Asset-based profitability measures would be preferred on these grounds, everything else being equal; however, return on assets should not be used in some situations (e.g., when the primary business activities of the taxpayer are distribution activities because the primary assets of distribution companies are people, which are not generally included in the asset base).

Operational problems may arise in using return on assets as the profit-level indicator. The existence of substantial intangible property will render this method suspect, unless the value of the intangible property can be accurately determined. Even if a company knows the value of its intangible property, the value of the intangible property owned by the comparable companies must be determined. Other factors that can reduce the reliability of return on assets measures are differences in the age and condition of assets that cannot be accounted for directly, and differences in the intensity of asset use, as measured by the asset turnover ratio. If the assets are of different vintages, or if there is substantial inflation in construction costs, their gross book values will not be comparable. It is not always easy to determine the ages of the assets, especially for companies being used as comparables, because data for their asset lives are not readily available. Replacement costs are not generally available or are not necessarily accurate when they are available.

Return on assets is used to evaluate manufacturing activities for many companies. This evaluation is consistent with the way the business is managed and is more likely to produce the true arm’s-length result than alternative profit measures. The issues raised in the previous paragraph should be handled through adjustments or through elimination of potential comparables to guarantee that the range implied by TNMM/CPM is reliable. Asset utilization rates (assets/sales) may differ so dramatically within an industry that use of return on assets without adjustment for the differences produces an unreliable result.

**Return on Sales** The return on sales profit indicator, while not grounded as firmly in economic theory, has several advantages compared with return on assets:

- Both net profit and sales (turnover) are generally accepted concepts and tend to be defined the same way across companies and countries.
- Both net profit and sales are commonly reported line items, whereas it is not always possible to obtain comparable, reliable gross profit information.
- The net profit-to-sales ratio (return on sales) is commonly used by many businesses to evaluate performance, so the data needed to apply it are relatively easy to obtain, and the results are easily understood by operating management.

The OECD Guidelines list several considerations to take into account when deciding which margin to use, including “how well the value of assets employed in

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7Guidelines, B.3.41.
the calculations is measured (e.g., to what extent there is intangible property, the value of which is not captured on the books of the enterprise), and the factors affecting whether specific costs should be passed through, marked up, or excluded entirely from the calculation.” This language does not provide much guidance as to the choice of a profitability measure. Moreover, the measure chosen can have a significant impact on the validity of the transfer prices. Return on sales is generally the best measure when evaluating a distributor (or other type of selling company), while return on assets is generally the best measure when evaluating a manufacturing company. The return on assets method may not work well for a contract manufacturer in a very labor-intensive industry such as a maquiladora.

**Determining the Appropriate Time Period for Analysis**

Once the profit measure or measures have been chosen, they must be computed for each of the comparables and for the controlled transaction. The number of years of financial data that should be considered is open to question. The Guidelines provide no specific advice on this point; they merely state, “Multiple year data should be considered . . . to take into account the effects on profits of product life cycles and short-term economic conditions.” This issue can be divided into several subissues.

**Decision to Use Multiple Years** Multiple-year data provide many advantages. Businesses are subject to “shocks,” events that occur only once and create an abnormal “blip” in company profits. For example, having the roof of a plant destroyed by a hurricane and requiring 6 months to rebuild would cause the return on assets to be much lower than normal for that year, but this untoward event should not affect the company’s transfer pricing. The use of multiple years smooths out the results and in general eliminates the short-run issues that may lead taxpayers or tax collectors to reach inappropriate conclusions regarding the adequacy of transfer pricing policies.

A second advantage of using multiple years concerns companies that use market penetration strategies. During the market penetration period, the profits of the enterprise will be lower than normal. Ordinarily, it is expected that a company engaged in a market penetration strategy will earn above-normal profits after the market penetration period to provide a return on its investment (i.e., the below-normal profits it earned during the penetration period); however, sometimes the “market penetration” is merely “market maintenance” and is pursued to allow the company to remain in business in the face of intense competition. In such cases, no return to the investment accrues to the company because the market conditions do not allow it. In these cases, a multiple-year analysis may be required to adequately assess the company’s transfer pricing policies.

**Determining the Appropriate Time Period** There are many approaches in determining the appropriate number of years to be used in applying TNMM. Suppose the com-
pany in question operates in a cyclical industry. Assume further that the company is attempting to determine a transfer pricing policy that can be applied year after year in the absence of changes in business operations. In this case, when evaluating the company’s overall profitability, it is not possible to choose one profitability number at the beginning of time and apply that number year in and year out. The profitability amount is affected by the business cycle; sometimes it will vary significantly within the business cycle. In this situation, it is necessary to use the entire business cycle to determine the range of net margins under the transactional net margin method.

Consider another example in which the company in question operates in a very stable industry, where neither the business cycle nor the product cycle affects margins over time. In this case, the time period to be used in computing the arm’s-length range should be just broad enough to ensure that the shocks referred to earlier are averaged out. While the time period must be determined on a case-by-case basis, 3 or more years generally produce acceptable answers.

Determining the "Average" or the "Range" An “average” can be computed in several ways using multiple-year data. Margins can be computed for each firm, across time, with a simple average being calculated. Alternately, margins can be computed using a weighted average, so that years with higher sales will have more weight. By contrast, a yearly average of all comparables (either simple or weighted) could be computed, with these averages then averaged across time. The method of averaging depends, to some degree, on the reasons for using multiple-year data. If the overall business cycle is considered, averaging the individual results for each year may be the preferred method. In this case, the firm-to-firm differences within a year are suppressed, so that the overall pattern of profitability across time becomes clearer.

Averaging results within a year is not as meaningful if the profitability of firms within an industry is highly affected by the product life cycle and different firms are in different portions of the product life cycle in any given year. The two techniques will give the same answer if simple averages are employed.

Testing the Reasonableness of Results

While the Guidelines do not stress the importance of “testing the reasonableness” of the resulting transfer pricing policy, we believe this is essential. Therefore, the final step in determining transfer prices using TNMM (or any other method) is to check the reasonableness of the results using alternative measures or methods. If the true arm’s-length range has been determined, it will be supported by alternative pricing measures. If significant differences occur in application of multiple methods, it is virtually always the result of errors in either the comparables selection or application of the method.

Calculating Transfer Prices Using TNMM

The following two examples provide guidance on applying TNMM to determine transfer prices.
EXAMPLE 1

Determining a Transfer Price Based on the Return-on-Assets Measure

Designer Dolls Ltd. (DDI), located in the United Kingdom, has two subsidiaries, one in the United States and one in Canada. Both subsidiaries manufacture designer dolls, using the unique technology developed by DDI. Both perform no other functions. The factories in the two countries were built in the same year, and the U.S. factory is larger. The output of the U.S. factory is sold to DDI, while the output of the Canadian factory is sold to a third-party distributor.

DDI uses return on assets (ROA) to evaluate the performance of all its manufacturing plants and companies. DDI operates in a capital-intensive industry where efficient utilization of capital assets is essential to its survival. Because ROA is used by operating management to evaluate and manage the business, it is appropriate to use ROA to determine transfer prices in the absence of data to apply transaction-based methods. It is also appropriate to use ROA as a test of reasonableness for prices determined using one of the transaction-based methods.

The Canadian subsidiary is earning a 10 percent return on assets employed, based on original cost of the assets. The two factories are the only producers of this type of designer dolls in the world. The designer dolls are produced using a very unusual manufacturing process, so no outside comparables are available. The following process is used to determine the appropriate price to pay the U.S. subsidiary for designer dolls.

The U.S. factory employs assets with an original cost of $10 million. Based on this cost and a 10 percent ROA, the U.S. subsidiary should earn net profits of $1 million on its total designer doll sales. The subsidiary sells 500,000 designer dolls per year, so the per-doll net profit should be $2. The subsidiary incurs total costs (costs of goods sold plus general and administrative expenses) of $10 per doll. The price charged to DDI should therefore be $12 per doll.

Companies typically restate this profitability analysis to a cost-plus or a resale price method for ease of application. They do so primarily because responsibility for computation and the management of day-to-day prices is relegated to very low levels within a company. In all probability, the company will convert the pricing to a markup on standard cost so that implementation of the pricing can be mechanized for the clerks who actually determine the prices. In this example, the transfer pricing policy is cost plus 20 percent on total cost.

EXAMPLE 2

Determining a Transfer Price Based on a Return-on-Sales Measure

Good Food is a Canadian distributor of healthy food products, which it purchases from its U.K. parent, Healthy Foods, Ltd., and sells to independent retailers. Good Food has identified three independent health food distributors that all buy from European manufacturers and sell to independent retailers. Good Food believes the three distributors perform exactly the same functions it does. Unfortunately, the dis-
tributors are privately owned, and only information on sales and net profits is available. Good Food therefore decides to use return on sales (ROS) as its profit-level indicator. Furthermore, Good Food believes that ROS is the appropriate measure of net profits because it uses the measure to evaluate its sales operations.

The ROS for the three distributors are 3, 3.5, and 4 percent, respectively. Good Food decides to use the midpoint (and mean) of the range, namely 3.5 percent. Good Food’s general and administrative costs have averaged 3 percent of sales for the last three years, and it anticipates that selling costs will be 6 percent of sales next year. Good Food must therefore earn a gross profit of 12.5 percent of sales to have a net margin of 3.5 percent of sales. Good Food’s net selling price per case is $8, so it must earn $1 per case to gain its desired net margin. Good Food would then pay $7 per case to Healthy Foods, Inc.

<table>
<thead>
<tr>
<th>Good Food Income Statement</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>8 (100)</td>
</tr>
<tr>
<td>COGS</td>
<td>7</td>
</tr>
<tr>
<td>Gross profit</td>
<td>1 (12.5)</td>
</tr>
<tr>
<td>SG&amp;A</td>
<td>.72 (9)</td>
</tr>
<tr>
<td>Operating income (EBIT)</td>
<td>.28 (3.5)</td>
</tr>
</tbody>
</table>

**WEAKNESSES AND STRENGTHS OF TNMM**

The primary weakness of TNMM is that it guarantees that a transaction will always be profitable to one of the participants. This does not always occur in arm’s-length relationships between unrelated parties. Neither the cost-plus, the resale price, nor the CUP methods guarantee net profits to any participant in a given transaction. The CUP method merely sets prices; the parties involved in the transaction must manage their businesses to be profitable given the prices. Distribution contracts typically provide that the price is computed as a given discount from end-sales prices. In some cases, distribution contracts provide for reimbursement of certain expenses. This complication does not change the result. Procurement contracts (particularly governmental contracts) are often written on a cost-plus basis. Contracts with contract manufacturers (or service providers) can easily be interpreted within the cost-plus framework, where cost is the “cost of sales,” not the total costs of the enterprise. In short, few, if any, contracts between unrelated parties guarantee one of the parties a bottom-line profit.

There are, however, good reasons to use the TNMM or CPM. Results from applying TNMM may be less affected by transactional differences than results from applying the CUP method. Net margins may be less sensitive to differences in functions than are the gross margins employed in the resale price and cost-plus methods; however, variations in the components of operating expenses, such as selling expenses, across companies in the same industry can be substantial, and operating expenses may also vary dramatically over time. In addition, companies may be penalized or unduly rewarded if their net margins are compared without adjustments for differences in efficiency.
One of the weaknesses of TNMM is the flip side of one of its advantages. In performing a TNMM analysis, one need analyze the functions and risks of only one side of the controlled transaction and need be concerned with only one set of financial information, which can be a real advantage when financial information from the counterparty to the controlled transaction is unavailable. By contrast, as the Guidelines point out, analyzing only one side of the transaction does not account for overall multinational enterprise profits from intercompany transactions and may leave other parties to the transactions with unreasonably high or low profits. We suggest that the overall reasonableness of every transfer pricing policy be tested by determining the impact the policy has on all affected parties, although this may not be appropriate in situations where extremely valuable intangibles are owned by one or more of the parties to the transaction.

In our experiences, it is rare that a transaction-based method cannot be used; however, the OECD and the IRS recognize that there are fact patterns under which transaction-based methods cannot be applied. The following example illustrates one situation in which the TNMM provides a transfer price when a transaction-based method does not.

Plastisale is a U.S. company that purchases Plasta (a plastic with unique properties) from its German subsidiary, Plastiman, and distributes Plasta in the United States. Plastiman operates under a license from Plastisale and is the only German manufacturer of Plasta. It does not sell Plasta to any uncontrolled parties. There are manufacturers, however, in several other European nations that produce Plasta under license from Plastisale and sell to third-party distributors. Plastisale has been unable to discover the prices at which the various manufacturers sell to third parties, but it has obtained information on net sales and on gross and net profit margins of the third-party manufacturers.

Plastisale initially wanted to use the gross profit margins to develop transfer prices using a cost-plus method. When Plastisale performed a functional analysis, it discovered that all the comparables had substantial plant-level administrative costs (as did Plastiman). Some comparables included plant-level administrative costs in the cost of goods sold because of differences in accounting requirements across countries. Other comparables included plant-level administrative costs in G&A costs as part of operating expenses. No information was available that would allow Plastisale to determine what portion of plant-level administrative costs were included in the cost of goods sold. Therefore, it was impossible to state the gross profits on a common basis. Net profit margins were determined consistently across countries, so that the transactional net profit margin could be used.

**COMPARISON WITH TNMM AND COMPARABLE PROFITS METHOD**

Multinational companies should be interested in achieving a common worldwide approach to transfer pricing. Without a common approach, the probability of double

9Guidelines, B.3.31.
taxation is unacceptably high. This section evaluates whether the differences between the TNMM and the CPM can lead to double taxation.

**CPM**

The CPM evaluates whether the amount charged in a controlled transaction is arm’s length, based on objective measures of profitability (profit-level indicators), which are derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Profit-level indicators are “ratios that measure relationships between profits and costs incurred or resources employed.” Several profit-level indicators can be used, depending on the facts and circumstances of the tested party. Common profit-level indicators include rate of return on assets and financial ratios such as operating profits to sales or gross profits to operating expenses. The taxpayer must decide which profit-level indicator is most appropriate, or if a combination of profit-level indicators should be used. If a combination is used, the taxpayer must then determine the weights given to the various indicators.

The taxpayer must also decide which party to the transaction should be used as the tested party. The tested party is the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Generally, the tested party will not own valuable intangible property or have other attributes that would differentiate it from uncontrolled comparables.

Profit-level indicators are applied to the tested party’s actual financial data associated with the controlled transactions under study. The tested party’s profit-level indicators are then compared to those of uncontrolled comparables. Adjustments may be needed if there are wide discrepancies between the tested party and the comparables or among the comparables.

**Comparison of TNMM and CPM**

There are substantial similarities between TNMM and the comparable profits method described in Treasury Regulation 1.482-5. Highlights of the two methods are shown in Table 13.1.

Several differences exist in application between TNMM and CPM. One minor difference is that the OECD Guidelines recommend using uncontrolled transactions entered into by the taxpayer (internal comparables) to determine margins, if possible, before using comparable transactions between unrelated parties. The IRS regulations have no such suggestion. The use of internal comparables is certainly consistent with the U.S. regulations and, no doubt, would be determined to be more reliable as defined by the U.S. regulations than would purely third-party data (exter-

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10Treas. Reg. § 1.482-5(a).
A second difference between TNMM and CPM is that the IRS regulations specifically recommend using three years of data, whereas the OECD Guidelines merely suggest the use of multiple years. This difference, likewise, should not be fatal to efficient worldwide tax administration. The U.S. regulations are broad enough to allow the use of an “appropriate” number of years so long as they are adequately explained. The OECD Guidelines are a little easier to work with in selecting the number of years because the presumption of business reality pervades their language. Business reality is not so clear in the U.S. regulations.

A third difference between TNMM and CPM is that the OECD Guidelines require the numerator of all the profit-level indicators to be the net margin, whereas the IRS regulations propose the ratio of gross profit to operating expenses as one of the profit-level indicators, the so-called Berry ratio. The IRS thus allows an additional profit indicator that can be helpful when comparables have different levels of operating expenses or when data from many countries are being used to determine transfer prices. We see the Berry ratio as useful in evaluating comparables under certain circumstances and hope that the OECD Guidelines are broad enough to accept its use, along with various other mechanisms of guaranteeing that the results of the comparable analysis are properly applied.

The more substantive differences between the OECD Guidelines and the IRS regulations lie in their treatment of ranges. The Guidelines state that it is important to

| TABLE 13.1 Comparison of Comparable Profits Method and Transactional Net Margin Method |
|-----------------|-----------------|
|                  | Comparable      | Transactional Net |
|                  | Profits Method  | Margin Method     |
| Profit-level indicators | Three specified: | None stated explicitly |
|                      | • Operating income/operating assets | Numerator must be net margin |
|                      | • Operating income/sales | Denominator can be |
|                      | • Gross profit/operating expenses | • Sales |
|                      | Others allowed | • Assets |
|                      | Recommend current plus two previous years | • Costs |
| Years of data used   | Recommend multiple years |
| Preferred comparables | Nothing stated | Uncontrolled transactions of taxpayer, then third-party comparables |
| Arm’s-length range   | Use of interquartile range if no adjustments are made | Full range of results |
| Adjustment point     | To median, or mean, if outside range | None |
take into account a range of results when using the transactional net margin method. The use of the range in this context could help reduce the effects of differences in the business characteristics of associated enterprises and any independent enterprises engaging in comparable uncontrolled transactions, because the range would permit results that occur under a variety of commercial and financial conditions. One can conclude that if the OECD were faced with a wide range of returns on sales, for example, it would be willing to accept evidence as to where within the range the taxpayer should be.

For example, suppose the range of acceptable returns on sales for a distributor is 2 to 5 percent of sales. If a tax authority, following the OECD Guidelines, audited a distribution company in a year in which the company’s actual return fell outside that range, the tax authority might be willing to accept arguments that would place the controlled distribution company at one or the other extreme within the range. For example, the tax authority might accept arguments that the appropriate return is 2 percent in “bad” years (i.e., when the firm was seeking to penetrate or maintain a market), while the appropriate return might be 5 percent during good years. The IRS, however, according to the language of Treasury Regulation Section 1.482-1(e)(2), requires the adjustment to the midpoint of the range (mean or median) under all circumstances. This difference can be extremely important and should be reconciled by the two taxing bodies.

A further, important difference between TNMM and CPM is the use of the interquartile range, which excludes the top and bottom 25 percent of the range. The interquartile range is in the IRS regulations but not in the OECD Guidelines. In essence, the IRS allows taxpayers to use comparable data without adjustments for differences in functions and risks. In this case, the taxpayer is limited to the interquartile range for determination and evaluation of transfer prices. Three issues arise as a result:

1. Whether reliable results occur when no adjustments are made for function and risk differences (we think not)
2. Whether narrowing the range to the interquartile range achieves the same results as would have occurred had the appropriate adjustments been made (we think not)
3. Whether narrowing the range causes inappropriate high/low profits in the “tested party” (under certain circumstances, we think it does)

The following example illustrates the differences between TNMM and CPM. A U.S. manufacturer of puppets, Puppet Shows Inc. (PSI), has a German subsidiary, Pupdist, that distributes puppets in Germany and Austria. PSI also sells puppets to independent distributors in Italy and Spain for the same price (freight and insurance are paid by the buyer). PSI and Pupdist have been using the price paid by the Italian and Spanish independent distributors as the price charged by PSI to Pupdist, based on the comparable uncontrolled price method. PSI had performed a careful func-

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13Guidelines, B.3.45.
tional analysis and discovered that the three distributors all performed the same functions, bore the same risks, and employed very similar levels of assets. In particular, all three distributors owned warehouses, and the terms of sales were the same for all three distributors. In addition, the sales volumes were similar, and geographic differences among the three countries were not sufficient to require any adjustments to the price.

PSI is now facing an IRS audit of its transactions with its German subsidiary. As part of its analysis in support of its position, PSI identified three European companies that manufacture puppets and sell to both related and independent distributors. PSI was unable to discover the prices at which the puppets were sold to distributors but obtained information on the net profit margins, sales, and gross assets of 10 independent distributors of puppets. Information on gross profits was only available for the two independent distributors to which PSI sold puppets.

Using more distributors in the sample was preferable to basing the results on two comparables, particularly because these were the comparables on which the price was based initially. A functional analysis of these distributors was performed, and it was determined that all performed similar tasks and bore similar risks. One difference among the distributors was that some owned warehouses, whereas others leased them under long-term contracts. It was decided that this difference would create problems with application of the return-on-assets measure, but that the risks of owning a warehouse were not substantially different from the risks associated with a 20-year capital lease contract. As a result, the net profit-to-sales measure was chosen, and no adjustments were required.

Financial data from the five years before the year under audit were collected for all the comparable distributors and for Pupdist. It was decided that five years encompassed the introductory period of sales of puppets in Europe. Using this time period is consistent with the Guidelines and the IRS discussion of multiple years, so the average return for the five-year period for each distributor was computed. The five-year-average net profit to sales ratios for the 10 distributors was 4, 5, 5, 5.5, 6.5, 6.5, 7.5, 8, 9.5, and 10 percent, with a mean of 6.75 percent; the interquartile range was 5 to 8 percent.

The U.S. tax manager at PSI was surprised by the broadness of this range. To understand why this variation occurred, the manager interviewed personnel at the subsidiary and at the independent distributors to which PSI sold and learned that the reason for the wide variation was basically differences in efficiency among the distributors—the more efficient distributors earned substantially higher profits than the less efficient ones. The ROS for PSI’s German subsidiary was 9 percent of sales, near the high end of the range and outside the interquartile range.

At this point, PSI’s tax manager became nervous, knowing that 9 percent was within the range prescribed by OECD Guidelines and that business reality suggested that the subsidiary’s profit margin should be at the high end of the range. The U.S. authorities, however, might well use the interquartile range and conclude that, because the German affiliate was outside that range, an adjustment to the midpoint (6.5 percent) was appropriate. If the IRS makes this adjustment, it is reasonable to conclude that a properly conducted audit in Germany would determine that the
German affiliate’s 9 percent return was entirely appropriate, thus requiring that the issue be settled by the competent authority process, with the possibility that double taxation would result.

**CONCLUSION**

The TNMM endorsed in the OECD Guidelines and the comparables profit method are conceptually the same method of determining transfer prices. The differences between the two methods lie in the nuances of their application, particularly the IRS emphasis on the interquartile range and adjustment to the midpoint.

Several factors must be carefully considered when applying these profit-based methods. Many of the same factors must be considered in applying any transfer pricing method. The first major question is the identity of comparable transactions or comparable companies. Functional analyses of the affiliated party under study and the potential comparables must be performed to determine comparability. The second major question is which measure of profitability to use: return on assets or return on sales. The answer will depend on the type of company and industry under study. In the cases where there is substantial intangible property ownership or where the functions performed are primarily sales-related, return-on-assets measures are unlikely to be accurate.

The third major question concerns the number of years to include in the analysis. The basic idea is to include a full product cycle or business cycle, so that the impact of year-to-year anomalies is minimized. If a full product cycle is used to set prices, the affiliate will not be allowed the benefit of the peaks or the detriments of the valleys in the profit cycle, but will be appropriately profitable on average. This does not mimic real-world situations, but if the time period selected is appropriate, the result will be arm’s length over the entire period.

The use of multiple-year data is essential in the context of audits of transfer prices in which tests of reasonableness must be applied to determine whether the overall results make business sense. If the results for an affiliate lie within the range over the cycle, those results are consistent with arm’s-length transactions during that cycle and should not be subjected to adjustment for any year within the cycle.

Adjustments to the financial data of the comparable companies or of the affiliate must be made to reflect differences in their circumstances, including functions performed and risks borne, to obtain reliable results. Finally, all of the data should be used in constructing ranges, with the affiliate’s place in the range determined by its particular facts and circumstances. This analysis requires judgment based on the economic circumstances and creates the potential for double taxation arising from differences in the U.S. and OECD approaches to profit-based methods of determining transfer prices.

In sum, TNMM and CPM are useful tools in a taxpayer’s kit, but neither is a substitute for a carefully performed study employing transaction-based measures such as comparable uncontrolled price, resale price, and cost-plus methods. As the Guidelines state, “The recognition that the use of transactional profit methods may
be necessary is not intended to suggest that independent enterprises would use these methods to set prices. Instead, transactional profit methods are being recognized as methods that assist in determining in cases of last resort whether transfer pricing complies with the arm’s-length principle [emphasis added].” 14 The methods can be useful, however, in testing the reasonableness of prices determined by transaction-based methods.

14 Guidelines, B.3.54.
Avoiding Transfer Pricing Penalties
A penalty applies to Section 482–related tax underpayments. The penalty is imposed on any underpayment that is attributable to a substantial valuation penalty or to a gross valuation penalty. The penalty applies in either of two situations:

1. **The transactional penalty.** A transaction between persons described in Section 482.

2. **The net adjustment penalty.** A net Section 482 transfer pricing adjustment.

There are two penalty levels:

1. **20 percent penalty.** Twenty percent of the underpayment of tax that is attributable to the substantial valuation misstatement.

2. **40 percent penalty.** Forty percent of the underpayment of tax that is attributable to the gross valuation misstatement.

Figure 14.1 summarizes the transfer pricing penalty regime. The term *gross valuation penalty* is “gross” in the context of “extreme.” “Gross valuation” in this context is not analogous to “gross receipts,” does not mean “before expenses,” and is not the opposite of “net.”

**PLANNING**

The transfer pricing penalty can be very costly to many taxpayers because assessments are likely and the penalty is not deductible. As we shall see, some ameliorative provisions may eliminate the penalty, but for the most part these actions must be taken in advance of audit.

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1 I.R.C. § 6662(e).
2 Treas. Reg. § 1.6662-6(a)(1).
3 I.R.C. § 6662(h).
Treas. Reg. § 1.6662-6(a)(1).

Treasury Regulations Section 1.6662-6 provides the specifics of transfer pricing penalty. Taxpayers subject to this penalty regime might be able to successfully oppose the implementation of some facets of this regulation, but a wholesale attack of these regulations themselves is unlikely to prevail.

OVERVIEW

The transfer pricing penalty provisions are lengthy. The regulation is divided into seven sections, termed paragraphs, which are delineated as follows:

1. General provisions, which are described in paragraph (a)
2. Specific rules related to the transaction penalty, which are described in paragraph (b)
3. Specific rules related to the net adjustment penalty, which are described in paragraph (c)
4. Amounts that can be excluded for purposes of calculating the net adjustment penalty, as described in paragraph (d)
5. Special rules that apply to carrybacks and carryovers, as described in paragraph (e)
6. Coordination rules between penalties, as described in paragraph (f)
7. Effective dates of these provisions, as described in paragraph (g)

DETERMINATION OF AN UNDERPAYMENT

The transfer pricing penalty regulations apply to tax underpayments. As a result, the determination of an underpayment, including its cause and timing, are essential ingredients in ascertaining the validity of a penalty.

4 Treas. Reg. § 1.6662-6(a)(1).
The starting point in determining the underpayment is the taxpayer’s controlled transactions. By the term “controlled transactions” in this context, the drafters apparently are referring to transactions that are subject to Section 482; however, not every controlled transaction in fact may be subject to Section 482. The terms applied in the transfer pricing penalty provisions have the same meaning as identical terms used in the transfer pricing regulations.\(^5\) The determination of the presence of the underpayment is the tax return: The underpayment is determined from controlled transactions that are reported on the income tax return.\(^6\)

**Reported Results**

The phraseology of the regulations can cause some difficulties to the taxpayer and to the Internal Revenue Service (IRS). This subparagraph begins with “Whether an underpayment is attributable to a substantial or gross valuation misstatement . . . ,” suggesting that this clause applies only to determine whether the underpayment is substantial or gross, not to determine whether there is an underpayment. In addition, the clause pertaining to underpayments speaks of “an income tax return,” suggesting that reporting the income in a different year might vitiate the potential penalty. Results on the tax return are determinative for this computation. Amounts that differ from the transaction price initially reflected in the books and records of the taxpayer are not determinative for the computation.

**Amended Returns**

Filing an amended tax return may preclude the transfer pricing penalty, but only if the amended return antedates the audit. The results of controlled transactions that are reported on an amended tax return are used for this purpose only if the amended tax return is filed “before the IRS has contacted the taxpayer regarding the corresponding original return.”\(^7\) It will be difficult for the taxpayer to prove lack of “contact”; a better evidentiary rule would be to place the burden on the IRS to prove that contact took place.

Large corporations that are under continuous audit might not file an amended return per se. The transfer pricing penalty regulations accommodate to this procedure. The following activities constitute an amended return (assuming other compliance objectives are complied with):

- A taxpayer subject to the Coordinated Examination Program furnishes a written statement to the IRS.
- A taxpayer, when electing Accelerated Issue Resolution or similar procedures, furnishes a written statement to the IRS.

In order to comply with the de facto amended return rules, the taxpayer must satisfy the requirements for a qualified amended return.\(^8\) The IRS may prescribe a

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\(^{5}\) Treas. Reg. § 1.6662-6(a)(3).

\(^{6}\) Treas. Reg. § 1.6662-6(a)(2).

\(^{7}\) Id.

\(^{8}\) Treas. Reg. § 1.6664-2(c)(3).
different process by revenue procedure. If a taxpayer is a member of a consolidated group, these penalty regulations apply to the consolidated income tax return of the group.

**TRANSACTIONAL PENALTY**

The transactional penalty is one of the two types of transfer pricing penalties: the transactional penalty and the net adjustment penalty. The transfer pricing regulations provide two types of transactional penalties:

1. Substantial valuation misstatement
2. Gross valuation misstatement

**General Transactional Penalty Issues**

The mark (for computational purposes) against which the penalty is determined is “the amount determined under Section 482 to be the correct price.” The regulations do not further define the term “correct price,” but it appears that the drafters contemplated that the Section 482 correct price would be determined in court or as part of the stipulation process. IRS assertions of transfer price, in and of themselves, do not constitute a Section 482 amount that should be applied for penalty purposes.

The regulations state that the substantial valuation misstatement penalty or the gross valuation misstatement penalty could apply to any transaction between related persons. The “related person” threshold is too broad. The penalty could rightfully apply to parties subject to Section 482, but parties may be related to each other without being subject to Section 482. Section 482 is based on ownership or control, and Section 482 would not be applicable where the parties are related and there is no activity or the activity is at arm’s length.

**Substantial Valuation Misstatement Penalty**

The transactional penalty for substantial valuation misstatement applies in two situations:

1. The amount claimed on the return is 200 percent or more of the amount determined under Section 482 to be the correct price. *Example:* An item is sold to an affiliated business entity for $4,000. The correct Section 482 price is determined to be $8,000. The 20 percent substantial valuation misstatement penalty applies.
2. The amount claimed on the return is 50 percent or less of the amount determined under Section 482 to be the correct price. *Example:* An item is sold to an affli-
ated business entity for $4,000. The correct Section 482 price is determined to be $2,000. The 20 percent substantial valuation misstatement penalty applies.

**Gross Valuation Misstatement Penalty**

The transactional penalty for gross valuation misstatement applies in two situations:

1. The amount claimed on the return is 400 percent or more of the amount determined under Section 482 to be the correct price. *Example:* An item is sold to an affiliated business entity for $4,000. The correct Section 482 price is determined to be $16,000. The 40 percent gross valuation misstatement penalty applies.

2. The amount claimed on the return is 25 percent or less of the amount determined under Section 482 to be the correct price. *Example:* An item is sold to an affiliated business entity for $4,000. The correct Section 482 price is determined to be $1,000. The 40 percent gross valuation misstatement penalty applies.

**Reasonable Cause and Good Faith**

A taxpayer may be able to avoid the transactional penalty by demonstrating reasonable cause and good faith. A much more stringent exception applies to net Section 482 adjustments and is addressed subsequently in this chapter. The taxpayer may not be able to meet the reasonable cause and good faith requirements in the entirety, but may be able to meet the requirements in part. In that event, the penalty will not be imposed on that portion.

The taxpayer subject to the transactional penalty may have relied on professional analysis in determining its transfer pricing. This analysis might constitute reasonable cause and good faith. In this regard, whether the professional is an employee of the employer or is related to the employer is not determinative in evaluating whether the taxpayer reasonably relied in good faith on advice. The net adjustment penalty has a separate exculpation provision for reliance on a professional.

The net adjustment rule exempts the penalty because of reasonable cause and good faith. A taxpayer that meets the reasonable cause and good faith exemption from the net adjustment rule is treated as meeting the reasonable cause and good faith requirements as to the transactional penalty; however, a priority rule determines that the net adjustment rule takes precedence over the transactional penalty. The net adjustment exclusion rules apply if a substantial or gross valuation misstatement under the transactional penalty also constitutes (or is part of) a substantial or gross valuation misstatement under the net adjustment penalty.

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13 Treas. Reg. § 1.6662-6(b)(2).
14 I.R.C. § 6664; Treas. Reg. §§ 1.6662-6(b)(3) and 1.6664-4.
15 Treas. Reg. § 1.6662-6(d).
16 Id.
Services and Royalties

The transaction penalty applies to the price paid for property and the price paid for services. The transactional penalty raises some peculiar results for royalties, largely because they are more difficult to ascertain and value than are tangible property. For example, an engineering company licenses a trademark to its overseas distributor at a 2 percent rate. The Section 482 transfer pricing rate was determined to be 4 percent. This difference in royalty rates is sufficient to cause a gross valuation misstatement penalty to apply.

The transactional penalty raises more issues for services because such amounts might not have been reflected as a transfer price on the tax return. For example, a headquarters company provides as services what it believes is stewardship to its subsidiaries. In so doing, the headquarters company charges no fees to its subsidiaries. A Section 482 adjustment recharacterized the activities and imposed a transfer pricing adjustment where none existed. Any adjustment, regardless of how small, would be subject to the gross valuation substantial valuation penalty. In the mid-1990s, the IRS has often abated this penalty. Later taxpayers might not be as fortunate.

Aggregation

The transactional penalty depends on a formula:

\[
\frac{\text{Section 482 valuation}}{\text{Amount reflected on tax return}}
\]

As a result of this formulation, an aggregation of transactions may benefit the taxpayer, as shown in Example 1.

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Amount Reflected on Tax Return</th>
<th>Section 482 Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ 4,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>B</td>
<td>$36,000</td>
<td>$44,000</td>
</tr>
<tr>
<td>Aggregate</td>
<td>$40,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

Standing alone, transaction A would be subject to the 40 percent gross valuation misstatement penalty. Transaction B would not be subject to penalty. Combined, neither the substantial valuation misstatement penalty nor the gross valuation penalty would be imposed.

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17 Treas. Reg. § 1.6662-6(b).
In other situations, the aggregation of transactions is disadvantageous for the taxpayer, as shown here:

**EXAMPLE 2**

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Amount Reflected on Tax Return</th>
<th>Section 482 Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>$6,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>D</td>
<td>$31,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Aggregate</td>
<td>$37,000</td>
<td>$76,000</td>
</tr>
</tbody>
</table>

Standing alone, transaction C would be subject to the 20 percent substantial valuation misstatement penalty. Transaction D would not be subject to penalty. Combined, the substantial valuation misstatement penalty would be imposed on the entire amount.

Aggregation and disaggregation of transactions can be complex in the penalty context, just as it is for FSC or DISC income maximization, or selecting significant industry segments for foreign-owned U.S. corporations—all of which are discussed in the *Transfer Pricing Handbook*.

**NET ADJUSTMENT PENALTY**

The most onerous penalty, especially for large taxpayers, is the net adjustment penalty. There are two types of net adjustment penalties:

1. Substantial valuation misstatement
2. Gross valuation misstatement

Both types of net adjustment penalties rely on gross receipts. Tax accounting rules determine the gross receipts amount.\(^{18}\)

**Substantial Valuation Misstatement**

There is a substantial valuation misstatement if a net Section 482 adjustment is the lesser of the following:\(^ {19}\)

- $5 million
- 10 percent of gross receipts

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\(^{18}\) Treas. Reg. §§ 1.448-1T(f)(2)(iv) and 1.6662-6(c)(5).

\(^{19}\) Treas. Reg. § 1.6662-6(c)(2).
If a company has gross receipts of less than $50 million, the lesser amount is 10 percent of gross receipts, and item 2 applies. If a company has gross receipts of more than $50 million, the lesser amount is $5 million. Thus any medium-sized or large company (gross receipts of $50 million or more) with a $5 million adjustment is subject to the substantial valuation misstatement net adjustment penalty. For a company with gross receipts in the billions of dollars, a $5 million adjustment is minor in scope. Nevertheless, the substantial valuation misstatement net Section 482 adjustment applies.

**Gross Valuation Misstatement**

There is a gross valuation misstatement if a net Section 482 adjustment is the lesser of the following:

- $20 million
- 20 percent of gross receipts

If a company has gross receipts of less than $100 million, the lesser amount is 20 percent of gross receipts, and item 2 applies. If a company has gross receipts of more than $100 million, the lesser amount is $20 million. Thus any medium-sized or large company (gross receipts of $100 million or more) with a $20 million adjustment is subject to the gross valuation misstatement net adjustment penalty. For a company with gross receipts in the billions of dollars, a $20 million adjustment may be relatively minor in scope. The gross valuation misstatement net Section 482 penalty applies in that instance.

**Net Section 482 Adjustment**

The net Section 482 adjustment is the basis of this transfer pricing penalty. A different penalty, the transactional penalty, is discussed in the preceding section. The net Section 482 adjustment is determined in the following manner:

- All increases in the taxable income of a taxpayer for a taxable year that result from allocations under Section 482 are taken into account and added. Amounts carried from one taxable year to another are disregarded.
- Taxable income attributable to collateral adjustments is subtracted.

Certain amounts are excluded from net Section 482 adjustments. These amounts are excluded from the calculation of the net Section 482 adjustment. Substantial valuation misstatements and gross valuation misstatements that are subject to the transactional penalty are included in determining the amount of the net Section 482 adjustments. Coordination rules for both facets of the penalty may apply.

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20 Treas. Reg. § 1.6662-6(c)(3).
21 Treas. Reg. § 1.6662-6(c)(1).
22 Treas. Reg. § 1.482-1(g).
23 Treas. Reg. § 1.6662-6(d).
24 Treas. Reg. §§ 1.6662-6(c)(1) and 1.6662-6(f).
SETOFF ALLOCATION RULE

Setoffs\textsuperscript{25} may apply to some but not all of the allocations made under Section 482. Setoffs apply ratably if the taxpayer meets the requirements to exclude amounts from net Section 482 adjustments if some, but not all, allocations under Section 482 apply to the setoff. This example from the regulations illustrates pro rata allocation:

\begin{example}

The IRS makes three Section 482 adjustments for the taxable year:\textsuperscript{26}

\begin{enumerate}
  \item Adjustment attributable to an increase in gross income caused by an increase in royalty payments $9,000,000
  \item Adjustment attributable to an increase in sales proceeds due to a decrease in the profit margin of the related buyer $6,000,000
  \begin{align*}
    \text{Subtotal} & = 15,000,000 \\
    \text{3. Adjustment because of the setoff} & = -5,000,000 \\
    \text{Total Section 482 adjustments} & = 10,000,000
  \end{align*}
\end{enumerate}

The fact pattern discloses that net Section 482 exculpation applies to Adjustment 1, but not to Adjustment 2.\textsuperscript{27} The pro rata rule allocates the setoff adjustment to Adjustment 1 and Adjustment 2. The total of the Section 482 adjustments is $15 million, which becomes the denominator of the setoff equation. The $5 million setoff amount is allocated ratably: $5 million\times$9 million/$15 million or $3 million for Adjustment 1; $5 million\times$6 million/$15 million or $2 million for Adjustment 2. For Adjustment 1, the $9 million amount, reduced by $3 million to $6 million, is not subject to penalty. For Adjustment 2, the $6 million amount, reduced by $2 million to $4 million, would be subject to penalty as the net Section 482 adjustment; however, the 20 percent substantial valuation misstatement penalty applies only if the net Section 482 adjustment is greater than the lesser of $5 million or 10 percent of gross receipts.

The pro rata setoff penalty rule is subject to challenge because the regulations apply the exempt amount (here, $9 million) against the setoff allocation (here, $5 million) times the pro rata allocation ($3 million divided by $5 million). This process causes $3 million of the penalty exculpation to be eliminated. Arguably, the $5 million offset should apply against the $6 million amount, leaving a penalty exposure of $1 million.

\textsuperscript{25}Treas. Reg. § 1.482-1(g)(4).
\textsuperscript{26}Treas. Reg. § 1.6662-6(c)(4), Example (i).
\textsuperscript{27}Id., Example (ii).
A taxpayer is treated as having reasonable cause\textsuperscript{28} for any portion of an underpayment attributable to a net Section 482 adjustment only if the taxpayer meets the exclusionary rule for net Section 482 adjustments.\textsuperscript{29}

**NET ADJUSTMENT PENALTY EXAMPLES**

The net adjustment penalty regulation contains five examples that explain the penalty:\textsuperscript{30}

**Simple Penalty**

The IRS makes three Section 482 adjustments for the taxable year. None of the adjustments is excluded from net Section 482 exculpatory provisions:\textsuperscript{31}

1. Adjustment attributable to an increase in gross income because of an increase in royalty payments $2,000,000
2. Adjustment attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer $2,500,000
3. Adjustment attributable to decrease in the cost of goods sold because of a decrease in the cost-plus markup of a related seller $2,000,000

$6,500,000

The net Section 482 adjustment is $6.5 million, which is greater than $5 million. The substantial valuation misstatement applies for penalty purposes.

**The 10 Percent Substantial Valuation Misstatement**

The IRS makes three Section 482 adjustments for the taxable year. None of the adjustments are excluded from net Section 482 exculpatory provisions. The taxpayer has gross receipts of $60 million.\textsuperscript{32}

1. Adjustments attributable to an increase in gross income because of an increase in royalty payments $11,000,000
2. Adjustments attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer $2,000,000
3. Adjustment because of a setoff $9,000,000

$4,000,000

\textsuperscript{28} I.R.C. §§ 6664(c) and 6662(e)(3)(D); Treas. Reg. § 1.6662-6(c)(6).
\textsuperscript{29} I.R.C. § 6662-6(d).
\textsuperscript{30} Treas. Reg. § 1.6662-6(c)(7).
\textsuperscript{31} Id., Example (1).
\textsuperscript{32} Id., Example (2).
The net Section 482 adjustment is $4 million, which is less than $5 million and less than 10 percent of $60 million or $6 million. There is no substantial valuation misstatement for penalty purposes.

**Consolidated Return Application A**

The affiliated group files a consolidated tax return. The IRS makes three Section 482 adjustments for the taxable year. None of the adjustments are excluded from net Section 482 exculpatory provisions.33

<table>
<thead>
<tr>
<th>Adjustments</th>
<th>Gross Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustment attributable to Member A</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Adjustment attributable to Member B</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Adjustment attributable to Member C</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Total Section 482 adjustments</td>
<td>$4,500,000</td>
</tr>
</tbody>
</table>

The net Section 482 adjustment of $4.5 million is greater than the lesser of $5 million or 10 percent of gross receipts of $43 million or $4.3 million. A substantial valuation misstatement applies for penalty purposes. Perhaps the taxpayer could argue that the substantial misstatement applies only to Member C because the adjustment is 18 percent ($2 million divided by $11 million). In that event, the substantial valuation misstatement applies to $2 million rather than $4.5 million. Here, disaggregation might be proper because the penalty is not dependent on the $5 million requirement.

**Consolidated Return Application B**

The affiliated group files a consolidated tax return. The IRS makes three Section 482 adjustments for the taxable year. None of the adjustments are excluded from the net Section 482 exculpatory provisions.34

<table>
<thead>
<tr>
<th>Adjustments</th>
<th>Gross Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustment attributable to Member A</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Adjustment attributable to Member B</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Adjustment attributable to Member C</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Total Section 482 adjustments</td>
<td>$7,000,000</td>
</tr>
</tbody>
</table>

The net Section 482 adjustment of $7 million is greater than the lesser of $5 million or 10 percent of gross receipts of $95 million or $9.5 million. The substantial valuation misstatement applies. An attempt to disaggregate the members would not be acceptable to the IRS. The 10 percent test would not apply to any member.

33 Id., Example (3).
34 Id., Example (4).
Instead, the penalty is based on the $5 million requirement and would be vitiating by the disaggregation.

**Consolidated Return Application C**

The affiliated group files a consolidated tax return. The IRS makes three Section 482 adjustments for the taxable year. None of the adjustments are excluded from the net Section 482 exculpatory provisions.35

<table>
<thead>
<tr>
<th></th>
<th>Adjustments</th>
<th>Gross Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. A</td>
<td>$2,000,000</td>
<td>$10 million</td>
</tr>
<tr>
<td>2. B</td>
<td>$1,000,000</td>
<td>$35 million</td>
</tr>
<tr>
<td>3. C</td>
<td>$1,500,000</td>
<td>$40 million</td>
</tr>
<tr>
<td>Total</td>
<td>$4,500,000</td>
<td>$85 million</td>
</tr>
</tbody>
</table>

The net Section 482 adjustment of $4.5 million is less than the lesser of $5 million or 10 percent of gross receipts of $85 million or $8.5 million. The substantial valuation misstatement does not apply. In this situation, it would not be advantageous to seek disaggregation. Member A would then be subject to the substantial valuation misstatement because the adjustment is more than 10 percent of gross receipts, $2 million divided by $10 million, or 20 percent.

**NET SECTION 482 EXCULPATORY PROVISIONS**

The net Section 482 exculpatory provision eliminates the transfer pricing penalty if the taxpayer satisfies intricate, specific requirements. The net Section 482 penalty is quite likely to be applied to large taxpayers having a significant volume of transactions because of the potential for transfer pricing adjustments. As a result, many large taxpayers are seeking to comply with these exculpatory rules, raising the specter that partial compliance might not provide exculpation, but instead provide the IRS with a road map of the taxpayer’s operations. There are three specific types of exculpation; the taxpayer can achieve exculpation by any one of the following:36

- Application of a specific Section 482 method
- Application of an unspecified method
- Certain foreign-to-foreign transactions

The transactional penalty might apply regardless of exculpation from the net Section 482 adjustment. In addition, penalties specific to foreign-owned U.S. corporations might apply. Exculpation of the net Section 482 adjustment penalty through application of a specific Section 482 method is discussed next.

35 Id., Example (5).
36 Treas. Reg. § 1.6662-6(d)(1).
APPLICATION OF A SPECIFIED SECTION 482 METHOD

A taxpayer may be able to exculpate its transactions from the net Section 482 adjustment penalty through use of a procedure for a specified Section 482 method. Other exculpatory provisions are discussed under “Net Section 482 Exculpatory Provisions.” To comply with the specified Section 482 method, the taxpayer must do all of the following:37

- Meet general requirements.
- Meet specified method requirements.
- Meet documentation requirements.

The net Section 482 transfer pricing penalty is precluded if an amount is excluded from the calculation of a net Section 482 adjustment. To do so, the taxpayer must meet both a specific method requirement and a documentation requirement. The specified method requirement necessitates that the taxpayer apply a specified method, a method described in the regulations under Section 482, and the method must apply to transactions of the type under review.38

A qualified cost-sharing arrangement is considered a specified method.39 An unspecified method is not considered a specified method,40 but a taxpayer may be able to exculpate itself from the net Section 482 adjustment penalty even though the taxpayer applies an unspecified method.41 Nevertheless, the transactional penalty42 and penalties specific to foreign-owned U.S. businesses might apply. The specified method requirement is discussed next.

SPECIFIED METHOD REQUIREMENT

A taxpayer applying a specified transfer pricing method must meet the specified method requirement to exculpate itself from the net Section 482 adjustment penalty.43 A different rule applies when a taxpayer uses an unspecified method.44 Nevertheless, the transactional penalty and penalties specific to foreign-owned U.S. businesses might apply. A taxpayer seeking to use the specified method requirement must comply with the documentation requirement.45

The specified method requirement imposes general standards upon the taxpayer that can be open to dispute between the taxpayer and the IRS. The specified method

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37 Treas. Reg. § 1.6662-6(d)(2).
38 Treas. Reg. § 1.6662-6(d)(2)(i).
39 Id. and § 1.482-7.
40 Treas. Reg. §§ 1.6662-6(d)(2)(i), 1.482-3(e), and 1.482-4(d).
41 Treas. Reg. § 1.6662-6(d)(3).
42 Treas. Reg. § 1.6662-6(b).
43 Treas. Reg. § 1.6662-6(d)(2)(i).
45 Treas. Reg. §§ 1.6662-6(d)(2)(i) and 1.6662-6(d)(2)(iii).
requirement imposes seven specific standards, for which disputes between the taxpayer and the IRS are also possible.

General Requirements of the Specific Method Requirement

The specified method requirement is met if the taxpayer “selects and applies” a specified method in “a reasonable manner.” The regulations do not further define “selects and applies,” but the interpretation of this clause can be a dispute item between the taxpayer and the IRS. The regulations then seek to define “a reasonable manner.”

The regulations provide that the taxpayer’s selection and application of a specified method is reasonable if two conditions and an activity are satisfied. The conditions are “the available data” and “applicable pricing methods.” The availability of the data, in particular, is a disputed item by the taxpayer and the IRS. The author urges taxpayers to maintain a chronological log indicating when data items are received and when these data items are implemented. The activity that connotes reasonableness is a conclusion by the taxpayer that the transfer pricing method and the application of that method provided “the most reliable measure” of the arm’s length result under the principles of the best method rule. This conclusion on the part of the taxpayer must be reasonable. The “most reliable measure” standard is a frequent dispute item between the taxpayer and the IRS.

The regulations then seek to define “most reliable measure.” A taxpayer can conclude that a specified method provided the most reliable measure of an arm’s length result only if the taxpayer has made a “reasonable effort” to “evaluate” the potential applicability of other specified methods in a manner consistent with the principles of the best method rule. This conclusion on the part of the taxpayer must be reasonable. The phrase “reasonable effort” is a potential source of dispute between the taxpayer and the IRS, but the author has not found this dispute to apply in practice. Instead, disputes between the taxpayer and the IRS apply to the evaluation process.

The regulations then seek to describe the transfer pricing evaluation process. The extent of evaluation generally depends on the “nature of the available data” and may “vary from case to case and from method to method.” It is important for a taxpayer seeking the penalty exculpation to maintain a chronological log indicating when data items are received and when data items are implemented.

This evaluation of the transfer pricing process, according to regulations, “may not” entail an exhaustive analysis or detailed application of each method. “May not,” in this context, is more likely to be construed in the nonmandatory permissive sense of “might” or “may or may not” rather than as a prohibition on these activities.

The taxpayer is to undertake a “reasonably thorough search for relevant data.” The taxpayer is then to consider which transfer pricing method would provide the “most reliable measure” of an arm’s length result given that data. The “most reliable measure” standard is already being applied to determine reasonability of the trans-

46 Treas. Reg. § 1.6662-6(d)(2)(ii).
47 Id. and § 1.482-1(c).
fer pricing in the first place, suggesting an argument that this facet of the regulations might be circular in reasoning. Taxpayers and the IRS might dispute whether the search is reasonably thorough or whether the search is not reasonably thorough.

The regulations provide that “the nature of available data” (which is not further defined in the regulations) may enable the taxpayer to conclude that a particular specified method provides “a more reliable measure” (which is not further defined in the regulations) of an arm’s-length result than one or more of the other specified methods. The conclusion of the taxpayer must be reasonable. Whether the taxpayer’s conclusion is reasonable must be based on all the facts and circumstances, which are discussed in the remainder of this section of the penalties chapter.

No further consideration of other specified methods is needed if the preceding preconditions are satisfied. In this context, taxpayers and the IRS have been arguing about measures of reliability. The regulation also points out that it is not necessary for a taxpayer to conclude that the selected methods provide a “more reliable measure” of an arm’s-length result than any unspecified method.

The regulations refer to “a more reliable measure,” suggesting that a taxpayer that selects a transfer pricing method that provides one more reliable measure, but not more than one reliable measure, can avoid the net Section 482 adjustment penalty.

Experience and Knowledge

The first of seven specific standards under the specified method requirement, which is part of the specified Section 482 method of exculpation from the penalty, is experience and knowledge. Experience and knowledge of the taxpayer are facts and circumstances that are taken into account in ascertaining culpability for penalty exculpation purposes. All members of the taxpayer’s controlled group are taken into account for this purpose. The specific penalty provisions for foreign-owned U.S. businesses may exempt a taxpayer from the monetary penalty because of the taxpayer’s experience and knowledge.50

Reliable Data

The second of seven specific standards under the specified method requirement, which is part of the specified Section 482 method of exculpation from the penalty, is reliable data. Reliable data are facts and circumstances that are taken into account for penalty exculpation purposes.51

A taxpayer seeking to avoid the penalty under the reliable data facts and circumstances portion of the specified method requirement must engage in a “reasonably thorough search” for the data necessary to determine which method should be selected and how it should be applied. The clause “reasonably thorough search” is a

48 Id. and § 1.482-8.
contentious issue for taxpayers and the IRS. The regulations specify that the expense of additional efforts to locate new data in determining the scope of a reasonably thorough search may be weighed against the likelihood of finding additional data that would improve the reliability of the results and the amount by which any new data would change the taxpayer’s taxable income.

The regulations address timing issues regarding the reliability of the data. A taxpayer must use the “most current reliable data,” a term not defined in the regulations, that is available before the end of the taxable year in question. The taxpayer is not required to search for relevant data that occurs after the end of the taxable year. Nevertheless, the taxpayer must maintain as a principal document any relevant data that the taxpayer obtains after the end of the taxable year if that data would help determine whether the taxpayer has reported its true taxable income.

**Specific Transfer Pricing Requirements**

The third of seven specific standards under the specified method requirement, which is part of the specified Section 482 method of exculpation from the penalty, is compliance with the specific transfer pricing method. The extent to which the taxpayer followed the relevant requirements set forth in regulations under Section 482 regarding the application of the transfer pricing method are facts and circumstances that are taken into account for penalty exculpation purposes.

**Professional Services**

The fourth of seven specific standards under the specified method requirement, which is part of the specified Section 482 method of exculpation from the penalty, is the use of professional services. The extent to which a taxpayer relies on a study or other analysis performed by a “professional qualified to conduct such analysis, including an attorney, an accountant, or an economist,” are facts and circumstances that are taken into account for penalty exculpation purposes. Such activities on the part of the taxpayer must be reasonable. The regulations do not specify whether an attorney, an accountant, or an economist is automatically treated as a professional qualified to conduct such analysis, or whether an additional standard, that of specific professional qualification, is imposed on attorneys, accountants, and economists. Furthermore, because the regulations use the word includes to describe professionals, it is uncertain whether other professionals such as engineers, statisticians, and industry specialists can qualify as eligible service providers.

The transfer pricing analysis study is to be objective, thorough, and well-reasoned. The professional can be an employee of the taxpayer or related to the taxpayer. These relationships are not determinative in evaluating the reliability of the study or analysis as long as the analysis or study is objective, thorough, and well-reas-

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54 Treas. Reg. § 1.6662-6(d)(2)(ii)(D).
soned. The regulations caution that reliance on the study or analysis is reasonable only if the taxpayer disclosed to the professional “all relevant information” regarding the controlled transactions at issue. As a result, the taxpayer should be able to provide a chronological log, in discovery, of the information provided to the professional. The taxpayer should be aware of any client confidentiality issues that could arise.

The regulations do not suggest that a transfer pricing analysis by a professional take place every year. Instead, the regulations provide for modification and adjustment of the study or analysis. If a study or analysis was relied upon in a prior year, and that analysis was reasonable, this study or analysis may be relied upon in the current year if the facts and circumstances have not changed, or if the study or analysis has been appropriately modified to reflect “any change” in facts and circumstances. The “any change” rule is too cautious. Instead, the regulations should have referred to “substantial changes.”

**More Than One Uncontrolled Comparable**

The fifth of seven specific standards under the specified method requirement, which is part of the specified Section 482 method of exculpation from the penalty, is the use of more than one uncontrolled comparable. Facts and circumstances that tend to exculpation from the penalty occur if the taxpayer attempts to determine an arm’s-length result by using more than one uncontrolled comparable, whether the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived from uncontrolled comparables.\(^{55}\) The regulations add that such a result generally would not likely be closest to an arm’s-length result.\(^{56}\)

**Prior Advance Pricing Agreement of IRS Approval**

The sixth of seven specific standards under the specified method requirement, which is part of the specified Section 482 method of exculpation from the penalty, is the use of a transfer pricing methodology reflected in an Advance Pricing Agreement or in an agreement with the IRS in a prior year. Facts and circumstances that tend to the exculpation from the Section 482 penalty are taxpayer reliance on a transfer pricing methodology developed and applied pursuant to an Advance Pricing Agreement for a prior taxable year, or “specifically approved” by the IRS pursuant to a transfer pricing audit of the transactions at issue for a prior taxable year.\(^{57}\) The parameters of “significantly approved” are likely to be a dispute issue. The preceding rule applies if the taxpayer applied the approved method reasonably and consistently with its prior application. This rule applies if the facts and circumstances have changed in a way that materially affects the reliability of the results and if the taxpayer makes appropriate adjustments to reflect such changes.

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\(^{56}\) Id., §§ 1.482-1(e)(2)(ii)(B) and 1.482-1(e)(3).

\(^{57}\) Treas. Reg. § 1.6662-6(d)(2)(ii)(F).
Size
The seventh of seven specific standards under the specific method requirement, which is part of the specified Section 482 method of exculpation from the penalty, is the smallness of size. Facts and circumstances that tend to the exculpation from the Section 482 penalty is smallness of size, the size of the net transfer adjustment in relation to the size of the controlled transaction in which the transaction arose.58

DOCUMENTATION REQUIREMENTS
A taxpayer seeking to avoid the net adjustment penalty must meet the documentation requirements, as well as specified method requirement.59 The documentation requirements, especially the contemporaneous documentation requirement, are extremely complex. This material is covered in the next chapter.

59 Treas. Reg. § 1.6662-6(d)(2)(iii).
Taxpayers that engage in transfer pricing transactions with their affiliates may be subject to penalties for erroneously computing their transfer prices; however, penalties that would otherwise apply to transfer pricing adjustments can be avoided if the taxpayer maintains specific “contemporaneous documentation.” Detailed and complex regulations limit the scope of these exculpatory provisions.

The maintenance of records is an active function, not a passive one. Pricing adjustments could lead to penalties, but keeping adequate records can prevent these penalties. The taxpayer must prepare affirmative responses to comply with Internal Revenue Service (IRS) audit procedures, a process that often necessitates compliance with even more complex and detailed requirements. Gone are the days when a company could demonstrate compliance with IRS recordkeeping rules by asserting that “we don’t throw anything out.”

The means by which the record maintenance procedure complies with the transfer pricing penalty regulations may also affect the client–professional relationship. The professional and the client could blame each other for failures to maintain contemporaneous documentation if and when the IRS prevails. Each could dispute the responsibility for document control, especially if the transfer pricing penalty is successfully asserted by the IRS. Claims against the accounting firm are possible, and actions or inactions on the part of the accounting firm could ultimately become the basis of malpractice claims. Professionals and their clients are well advised to review the record-keeping responsibilities in their engagement letters in light of the contemporaneous documentation procedure.

The Treasury has amplified and expanded the transfer pricing record-keeping requirements by using a backdoor approach to the accuracy-related penalty. Heretofore, foreign-owned U.S. corporations qualified for the record-keeping safe harbor by maintaining specific documents; no such requirement was imposed on U.S.

1 Treas. Reg. § 1.6662-6.
2 Treas. Reg. § 1.6038A-3(c).
owners of foreign subsidiaries. Now, such specific documents, termed “principal documents” and “background documents,”\(^3\) may have to be submitted to the IRS, regardless of whether the company is foreign-owned or U.S.-owned. Time is of the essence to the taxpayer; a taxpayer that is seeking to exclude a pricing adjustment from the determination of the penalty must submit these documents within 30 days of the IRS request.\(^4\)

**OVERVIEW**

A taxpayer seeking to apply a specified Internal Revenue Code (IRC) Section 482 method must meet two general requirements to avoid the transfer pricing penalty:

1. Detailed requirements for the method itself\(^5\)
2. Documentation that pertains to the method that has been selected\(^6\)

Both of these provisions are encompassed by Treasury Regulation Section 1.6662-6(d).

The consequences of the documentation provisions can be seen from the penalty regulations themselves, as the accuracy-related penalty regulations provide three methods of escape from the penalty:

1. By applying a specified Section 482 method\(^7\)
2. By applying an unspecified method\(^8\)
3. By using certain foreign-to-foreign transactions\(^9\)

An amount that would otherwise be included in the penalty computation is excluded through this escape process.

The regulations require the taxpayer to prepare two types of documentation; the temporary required three types of documentation.\(^10\)

1. Principal documents\(^11\)
2. Background documents\(^12\)
3. Tax return documentation\(^13\)

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A taxpayer can use an unspecified transfer pricing method rather than using a specified method. In this situation, the taxpayer that uses an unspecified method must meet detailed requirements for the selection of the method. The first two types of documentation are required for taxpayers that use unspecified methods: principal document and background requirements.

The documentation provisions under the penalty regulations are closely related to the reporting requirements for foreign-owned U.S. corporations, which were finalized in 1991. The transfer pricing penalty regulations enable the taxpayer to exclude a net Section 482 adjustment from the penalty calculation by complying with both the specified method requirements and the documentation requirements. This analysis pertains solely to the documentation requirements, which among practitioners are called the “contemporaneous documentation” rules.

GENERAL REQUIREMENTS FOR SPECIFIED SECTION 482 METHODS

If a taxpayer has selected a specified method and the IRS would otherwise apply a transfer pricing penalty, the taxpayer must meet the five general requirements:

1. Sufficiency
2. Reasonableness
3. Accuracy
4. Contemporaneous documentation
5. Compliance standards

These five standards are imposed on the taxpayer in addition to the taxpayer having to meet the detailed requirements for principal documents, background documents, and tax return documentation.

Sufficiency

The taxpayer seeking to exculpate itself from the transfer pricing penalty must maintain “sufficient documentation” to substantiate the transfer pricing method. The temporary regulations establish criteria for the sufficiency of documentation based on the reasonableness of the taxpayer’s conclusion regarding pricing methods and the accuracy of the result, but do not further define the meaning of “sufficient documentation.” Instead, the compliance procedures speak of “required documents,”

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14 Treas. Reg. § 1.6662-6(d)(3).
16 Treas. Reg. § 1.6662-6(d)(1).
18 Id.
which are then defined as principal documents,\textsuperscript{19} background documents,\textsuperscript{20} and tax return documentation.\textsuperscript{21}

\textbf{Reasonableness}

The taxpayer that is seeking to extricate itself from the transfer pricing penalty must maintain sufficient documentation to establish that its conclusion regarding the selection and application of the pricing method is reasonable.\textsuperscript{22} The taxpayer’s conclusion is to be based on the available data and the applicable pricing methods. The penalty regulations provide no further basis for determining reasonableness.

\textbf{Accuracy}

The exculpatory provisions for the transfer pricing penalty require the taxpayer to maintain documentation that provides that the taxpayer reasonably concluded that the transfer pricing method it selected is the “most accurate” measure of its transfer pricing.\textsuperscript{23} The documentation requirements use the phrase “most accurate” measure, but the specific method requirements within the transfer pricing penalty regulations speak of the “most reliable” measure. The difference between “accurate” and “reliable” is not specified within the penalty regulations.

The regulations require two types of accuracy measures. The first measure pertains to the transfer pricing method itself and the second to the application of the transfer pricing method.\textsuperscript{24} For both, the transfer pricing method must provide the most accurate measure of an arm’s-length result under the principles of the best method rule in Treasury Regulation Section 1.482-1(c). The delineation between the method and its application is uncertain, but it appears that the distinction is one of timing; the method could be selected in a preliminary matter before the taxable year begins, whereas the application phase appears to take place during the taxable year and the tax return period.

\textbf{Contemporaneous Documentation}

The transfer pricing penalty regulations impose strict timing requirements on the taxpayer. These provisions are known among practitioners as the “contemporaneous documentation” rules because the regulations provide the taxpayer with little time for compliance beyond the time in which the transactions take place. The taxpayer must provide the required documentation to the IRS within 30 days of the IRS’s request for the documents. The regulations specify that the documentation must be in existence when the tax return is filed, a requirement that further reinforces the contemporaneous documentation rules.\textsuperscript{25} The contemporaneous documentation

\textsuperscript{19} Treas. Reg. § 1.6662-6(d)(2)(iii)(B). See §53.4.
\textsuperscript{20} Treas. Reg. § 1.6662-6(d)(2)(iii)(C). See §53.5.
\textsuperscript{22} Treas. Reg. § 1.6662-6(d)(2)(iii)(A).
\textsuperscript{23} Id.
\textsuperscript{24} Id.
\textsuperscript{25} Id.
rules focus generally on the specified methods; analogous rules also apply to unspecified methods.

**Compliance Standards**

The transfer pricing penalty regulations impose stringent requirements on the taxpayer. Although absolute and total compliance is not mandatory, the regulations give the taxpayer little breathing room. The district director may, at his or her discretion, excuse a “minor or inadvertent failure” to provide required documents.\(^\text{26}\) The transfer pricing penalty regulations do not define either “minor” or “inadvertent,” and it is unclear whether both terms should be viewed as one item or whether both terms apply separately.

The exculpatory provisions apply only if the taxpayer has made a good-faith effort to comply with the documentation requirements.\(^\text{27}\) The term “good faith” is not further discussed in the regulations. In addition to limitations on excuses for the taxpayer’s failure to comply with the documentation requirements, the taxpayer must “promptly remedy” the documentation failure when it becomes known. The regulations do not further discuss issues of promptness. These compliance issues apply to both specified and unspecified methods.

**PRINCIPAL DOCUMENTS**

The regulations require the taxpayer to retain contemporaneous principal documents (as well as other documents) to avoid the transfer pricing penalty. The regulations state that the “principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer.”\(^\text{28}\) The meanings of this sentence are likely to be disputed by taxpayers and the IRS. At the outset, the term “basic transfer pricing analysis” is ambiguous. Taxpayers and the IRS will be left to determine when a pricing analysis is basic, rudimentary, or otherwise. In addition, “transfer pricing analysis” is ambiguous in this context. Furthermore, the requirement that the analysis be conducted by the taxpayer raises questions about the purchase of third-party documentation by the taxpayer.

The transfer pricing regulations require that the principal documents be accurate and complete,\(^\text{29}\) but the regulations do not provide an accuracy standard for these principal documents, nor do they provide a completeness standard. This lack of standards may mean that compliance under the accuracy and completeness rules could become a matter of dispute between taxpayers and the IRS. Moreover, it is uncertain whether the accuracy and completeness standards will be viewed as one criterion, or whether the regulations have imposed two criteria: one for accuracy and one for completeness.

\(^\text{26}\) Id.
\(^\text{27}\) Id.
\(^\text{28}\) Treas. Reg. § 1.6662-6(d)(2)(iii)(B).
\(^\text{29}\) Id.
Consider the following examples: In a given case, the IRS may assert that the taxpayer did not meet its responsibility to furnish its principal documents because the documents, although accurate, are not complete. Alternately, the IRS may assert that the documents are complete but not accurate. In another situation, the IRS might assert that documents taken as a whole did not accurately and completely describe the basic transfer pricing analysis.

The regulations for avoiding the transfer pricing penalty rely on the documentation of principal documents that “describe” the basic transfer pricing analysis. The verb describe may connote a low threshold for the taxpayer. In disputes between taxpayers and the IRS, the taxpayer may be able to assert, in a given case, that although it has not clearly demonstrated that the method selected is the best method, it has described the basic transfer pricing analysis.

The regulations for avoiding the transfer pricing penalty provide no further guidance as to principal documents, except for the sentence quoted earlier pertaining to a description of the basic transfer pricing analysis. The regulations state that principal documentation “must include” nine specific facets, as discussed in the rest of this section.

**Business Overview**

An overview of the business constitutes a principal document for the purpose of avoiding the transfer pricing penalty. The regulations do not define “overview” per se, but the overview of the business is to include “an analysis of the economic and legal factors that affect the pricing of its property or services.” Such factors are not enumerated within the documentation provisions. Moreover, such items could be better addressed in the eighth of the nine specific facets, an explanation of the economic analysis and projections. Also, the regulations appear to be addressed to the entire business of the entire group as a whole, but the regulations use the phrase “taxpayer’s,” suggesting that the overview pertains only to that business.

**Organizational Structure**

A description of the taxpayer’s organizational structure is a principal document for the purpose of avoiding the transfer pricing penalty. This description is to include an organization chart of who owns who or who owns what. The organizational structure and organization chart need not be complete, but the chart must cover all related parties engaged in transactions “potentially relevant” under Section 482. The relevancy of the potential transactions or their circumstances may be uncertain. The ownership and capital structure provisions within the regulations for the reporting foreign-owned U.S. businesses require more (i.e., a worldwide organization chart).

The organizational structure must include foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States.

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30 Id.
33 Id.
Arguably, all affiliated companies that import goods into the United States or export goods from the United States must be included within the organization chart. Companies that perform services in the United States must similarly be included in the organization chart. Companies that perform services outside the United States appear to be outside the purview of the organization chart provisions of the temporary transfer pricing penalty regulations. The regulations speak of “services in the United States” only; thus, foreign activities undertaken by U.S. persons, including companies in which the services are performed abroad by U.S. citizens or residents, appear to be outside the purview of the regulations.

Section 482 Documentation

A document that is explicitly required by the regulations under Section 482 constitutes a principal document; as such, this documentation must be retained by the taxpayer to avoid the potential transfer pricing penalty. The penalty provisions do not enumerate the specific Section 482 documents.

Method Selection

The documentation requirements that enable avoidance of the transfer pricing penalty require the taxpayer to describe the method selected and explain the reason why that method was selected. The description and explanation will be more complex for a company that selects different pricing methods for different product lines and different circumstances.

Rejected Methods

A taxpayer can avoid the transfer pricing penalty by, in addition to complying with the other provisions of the transfer pricing penalty, describing the alternative methods that the taxpayer considered. Such a description could conceivably take place by memorandum or otherwise. The taxpayer must also explain why the methods were rejected. In essence, the Treasury wants the IRS to track the taxpayer’s methodology. Application of the best method rule would normally require the taxpayer to review all of the specified methods.

Controlled Transactions

A description of controlled transactions is required by the transfer pricing penalty provisions and constitutes a principal document for the purpose of avoiding the transfer pricing penalty. The description of a transaction includes the terms of the sale and any internal data that are used to analyze those transactions. The term “internal data” encompasses the methodology itself. The temporary transfer pricing

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penalty regulations provide an example that demonstrates how the profit split applies, but the IRS might require comparably extensive documentation if other transfer pricing methods are selected.

The transfer pricing penalty exclusion regulations mandate that the taxpayer provide additional documentation if the taxpayer applies the profit split method. The mandatory documentation includes a schedule that provides the total income, costs, and assets for each controlled taxpayer participating in the relevant business activity.\(^\text{38}\) The regulations do not deal with this issue directly, but it appears that non-controlled entities that participate in the profit split should also be included in the analysis.

The profit split documentation rules use the terms “income, costs, and assets,”\(^\text{39}\) which are not defined within the transfer pricing regulations; arguably, the definitions in the foreign-owned U.S. corporation provisions under Treasury Regulation Section 1.6038A-3(c)(7) could apply to these terms. The foreign-owned U.S. corporation regulations speak of “operating profit,” which is defined by Treasury Regulation Section 1.6038A-3(c)(7)(v), and “identifiable assets,” which is defined by Treasury Regulation Section 1.6038A-3(c)(7)(iv).

The transfer pricing penalty regulations provide that the documentation must detail the allocations of “such items” (i.e., income, costs, and assets) that are made to “that activity” (i.e., the relevant business activity). These regulations also provide that profit split documentation must reflect adjustments for different accounting practices and currencies.\(^\text{40}\) The eighth of the nine criteria for principal documents, which pertains to economic analysis and projections, also addresses the profit split method.

### Comparables

The transfer pricing penalty exclusion regulations require the taxpayer to explain the comparables that were used.\(^\text{41}\) The taxpayer is to describe the comparables; explain how comparability was evaluated; and identify the adjustments, if any, that were made. The penalty regulations say nothing further about the comparables that could be required or used, or any related parameters.

### Economic Analysis and Projections

The transfer pricing penalty exclusion regulations require the taxpayer to explain the economic analysis and projections relied upon in developing the method.\(^\text{42}\) The specific method requirement of Treasury Regulation Section 1.6662-6T(d)(2)(ii)(D) does not require the use of an economist in conducting the transfer pricing study, but speaks of “a professional qualified to conduct such analysis or study, including an

\(^{38}\) Id.

\(^{39}\) Id.

\(^{40}\) Id.

\(^{41}\) Treas. Reg. § 1.6662-6(d)(2)(iii)(B)(7).

\(^{42}\) Treas. Reg. § 1.6662-6(d)(2)(iii)(B)(8).
attorney, accountant, or economist.” Thus it appears that the economic analysis can be performed or explained by any such professional. Nevertheless, this provision relates to the first of the nine facets of principal method documentation, the overview of the taxpayer’s business that includes economic factors.

The regulations provide an example of the economic analysis and projections needed if the profit split method is applied. In that situation, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits are split. The term economic analysis is not further defined in the regulations. In this regard, the sixth of the nine principal document requirements, in speaking of controlled transactions, also addresses itself to the profit split method.

**General Index**

The transfer pricing penalty exclusion regulations implicitly expect that the taxpayer will provide many documents to substantiate the transfer pricing analysis itself and the exculpatory provisions. For this reason, the taxpayer must prepare a general index encompassing both principal documents and background documents. In addition, the taxpayer is to describe the record-keeping system used for cataloging and accessing those documents. Apparently, the use of subindexes is discretionary on the part of the taxpayer.

**BACKGROUND DOCUMENTS**

The exculpatory provisions for the transfer pricing penalty require the taxpayer to maintain background documents, in addition to requiring principal documents. Specific provisions in the transfer pricing penalty regulations pertain to the inclusion or exclusion of documents, to relevancy, and to timing.

**Inclusion or Exclusion**

The transfer pricing avoidance regulations view background documents as supporting the principal documents. The principal documents are designed to reflect assumptions, conclusions, and positions that would substantiate the taxpayer’s transfer pricing policy. The assumptions, conclusions, and positions contained in the principal documents “ordinarily” will be reflected on, and supported by, additional background documents. Although the regulations use the phrase “ordinarily,” these regulations do not provide parameters for claiming an exception.

The mandatory scope of background documentation under the regulations is uncertain. The regulations provide that documents to support the principal documentation “may include the documents listed in section 1.6038A-3(c) that are not

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43 *Id.*
46 *Id.*
otherwise described in paragraph (d)(2)(iii)(B) of this section [which pertains to principal documents].” The preceding clause refers to documents that would be sufficient to satisfy the reporting safe harbor for U.S.-owned foreign corporations under Treasury Regulation Section 1.6038A-3(c). The transfer pricing rules and their penalty provisions apply equally to U.S.-owned and foreign-owned businesses; as a result, U.S.-owned businesses should strongly consider complying with the Treasury Regulation Section 1.6038A-3(c) provisions for transfer pricing purposes. The relevancy provisions, discussed later, may also be relevant in this regard.

In general, the transfer pricing regulations appear to be neutral between foreign-owned and U.S.-owned corporations. Disparities or inequalities could impair the acceptance of these regulations on a worldwide basis, perhaps subjecting the United States to retaliation. To preserve this equality in treatment, the reporting rules that apply to foreign-owned U.S. corporations under Treasury Regulation Section 1.6038A-3(c), and are incorporated by reference under Treasury Regulation Section 1.6662-6(d)(2)(iii)(C), should also apply to U.S.-owned foreign subsidiaries.

The transfer pricing penalty regulations do not provide taxpayers with a safe harbor for documenting transfer pricing, even though this documentation may be sufficient for foreign reporting purposes. Nevertheless, the use of the phrase “may include” suggests that taxpayers that provide less documentation to the IRS for the exculpation of transfer pricing than for the foreign reporting safe harbor are on risky ground.

The Treasury Regulation Section 1.6038A safe harbor requires the retention of six categories of records, each of which is described in extensive detail in the regulations:

1. Original entry books and transaction records
2. Profit and loss statements
3. Pricing documents
4. Foreign country and third-party filings
5. Capital structure records
6. Records of loans, services, and other nonsales transactions

Profit and loss statements are the most complex of the six categories enumerated here, as the regulations impose “materiality” criteria for three types of records: existing records, significant industry segments, and the high profit test, each of

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47 Id.
48 Treas. Reg. § 1.6038A-3(c)(2).
49 Treas. Reg. § 1.6038A-3(c)(2)(i).
50 Treas. Reg. § 1.6038A-3(c)(2)(ii).
51 Treas. Reg. § 1.6038A-3(c)(2)(iii).
52 Treas. Reg. § 1.6038A-3(c)(2)(iv).
53 Treas. Reg. § 1.6038A-3(c)(2)(v).
54 Treas. Reg. § 1.6038A-3(c)(2)(vi).
55 Treas. Reg. § 1.6038A-3(c)(3).
56 Treas. Reg. § 1.6038A-3(c)(4).
57 Treas. Reg. § 1.6038A-3(c)(5).
58 Treas. Reg. § 1.6038A-3(c)(6).
which is defined by the foreign reporting regulations. These provisions appear to apply to domestic and foreign business by reference to Treasury Regulation Section 1.6662-6(d)(2)(iii)(C) and Treasury Regulation Section 1.6038A-3(c)(3). The significant industry segment test relies on U.S.-connected products or services within the segment having worldwide gross revenue of $25 million or more; the high profit test applies when the revenue is $100 million or more. Both provisions are potentially relevant to large multinational businesses that export from or import to the United States in large quantities.

Relevance

An important facet of the transfer pricing penalty provisions is to establish the relevance of the background documents; relevance of the principal documents is conclusively presumed.59 After making reference to the foreign reporting provisions of Treasury Regulation Section 1.6038A-3(c), the regulations provide that “every document listed in those regulations may not be relevant to pricing determinations under the taxpayer’s specific facts and circumstances and, therefore, each of those documents need not be maintained in all circumstances.” This provision under Treasury Regulation Section 1.6662-6(d)(2)(iii)(C) strongly implies that maintenance of background documents is necessary, absent a showing by the taxpayer that the documentation is not relevant.

The transfer pricing penalty provisions of Treasury Regulation Section 1.6662-6(d)(2)(iii)(C) specify that maintenance of documents listed in Treasury Regulation Section 1.6038A-3(c) may not be sufficient to avoid the transfer pricing penalty and that other documentation may be required. The documents may be necessary to establish to the IRS that the taxpayer’s method was selected and applied in the way that provided the most accurate measure of an arm’s-length result under the best method rule in Treasury Regulation Section 1.482-1(b)(2)(iii).

Timing

A different and later time period applies to background documents compared with principal documents. Whereas principal documents must be furnished to the IRS within 30 days of the IRS request,60 the background documents need not be submitted to the IRS in response to a request for principal documents.61 The IRS is apparently not permitted to request principal documents and background documents at the same time, but the IRS can subsequently request background documents. If the IRS subsequently requests background documentation, a taxpayer must provide that documentation to the IRS within 30 days of the request.62 In other words, a second 30-day period is provided for background documentation. The regulations indicate that the district director has the discretion to extend the time period for producing background documentation beyond the second 30-day period.

62 Id.
TAX RETURN DOCUMENTATION

The transfer pricing penalty regulations had required that the taxpayer maintain “tax return documentation” together with principal documents and background documents to avoid the penalty. The term “tax return documentation” was somewhat misleading; the term did not pertain to the tax return itself, nor to its workpapers. Instead, the term pertained to two relatively narrow facets of tax return documentation, the profit split method and lump sum payments, both of which are discussed in this section.

Profit Split

The profit split method is a specified method, and as such can be used for transfer pricing purposes. Unlike the 1993 temporary transfer pricing regulations, the 1994 final transfer pricing regulations under Treasury Regulation Section 1.482-6 expanded the potential role of the profit split method. The temporary penalty regulations required extra documentation for the profit split method, and specific information had to be provided to the IRS if the taxpayer applied a profit split method.

The taxpayer was to prepare a statement indicating:

- Type of profit split employed
- Combined operating profit from the relevant business activity
- Split of the operating profit among controlled participants in that activity

The term “combined operating profit” is not defined in the transfer pricing penalty regulations, but the term “operating profit” is defined in the provisions for foreign-owned U.S. corporations under Treasury Regulation Section 1.6038A-3(c)(7)(v). The combination process is discussed in Treasury Regulation Section 1.6038A-3(c)(5)(ii). Both provisions were incorporated by reference to Treasury Regulation Section 1.6662-6(d)(2)(iii)(C).

The profit split statement was to be attached to a timely filed U.S. income tax return (with extensions). Such a statement must be titled “Disclosure of profit split methodology required by Sec. 1.6662-6T.”

Lump Sum Payments

Additional documentation was required if the consideration for a controlled transfer of an intangible was in the form of a lump sum payment. The penalty regulations do not specify whether the documentation is required, whether the taxpayer is the purchaser of the intangible, or whether the taxpayer is the seller. The documentation was in the form of a statement to the IRS. The taxpayer had to attach a statement to a timely filed U.S. income tax return (with extensions), and the taxpayer was required to continue to do so for each taxable year throughout the useful life of the intangible.

63 Former Treas. Reg. § 1.6662-6T(d)(2)(iii)(D).
intangible. The transfer pricing penalty regulations specify that the statement must disclose the calculation of the arm’s-length consideration for the transfer under the provisions of Treasury Regulation Section 1.482-4(f)(5). The statement was to be titled “Disclosure of lump sum payment required by Sec. 1.6662-6T.”

**DOCUMENTING UNSPECIFIED METHODS**

Separate documentation rules apply when the taxpayer seeks to substantiate its use of an unspecified method. The taxpayer is required to maintain “sufficient documentation” to establish that the unspecified method, as required by Treasury Regulation Section 1.6662-6(d)(3), is met. The term “sufficient documentation” is not further described by the transfer pricing penalty provisions.

**Analogous Methods**

The transfer pricing penalty rules have analogous specified and unspecified methods that apply to timing, the existence of records, and failures on the part of the taxpayer. The taxpayer using an unspecified method must provide the unspecified method documentation to the IRS within 30 days of the request for it—a timing rule that is analogous to the timing requirements for specified methods. Similarly, the documentation must be in existence when the return is filed—a requirement imposed for both specified and unspecified methods: hence the term “contemporaneous documentation.” The IRS has similar power over taxpayer compliance for specified methods and for unspecified methods. The regulations provide that the district director may, at his or her discretion, excuse a minor or inadvertent failure to provide documents, but only if the taxpayer has made a good-faith effort to comply and the taxpayer promptly remedies the failure when it becomes known.

The following disputes between the taxpayer and the IRS are likely to arise:

- The means of providing the documentation
- The meaning of the term “in existence,” including the use of electronic documentation, the destruction of documents through casualty or otherwise, and backdating, whether inadvertent or deliberate
- Interpretation of “minor or inadvertent”
- The meaning of “good-faith effort”
- The interpretation of “promptly” as to remedy that documentation as potentially available to a taxpayer

The general rules for principal and background documents that apply to specified methods also apply to unspecified methods. A separate tax return documenta-
tion rule applies to unspecified methods, and the taxpayer must disclose the unspecified method for the taxable year in which the unspecified method is applied. Such a statement must be titled “Disclosure of use of unspecified method required by Sec. 1.6662-6.”

Examples

The application of the documentation rule can be seen by two hypothetical situations, both of which affect the taxpayer’s decision regarding whether to notify the IRS. In each situation, the more lenient facets of the transfer pricing penalty procedure will not be available unless the taxpayer notifies the IRS.

1. A taxpayer believes that it is using a specified method, but the IRS nevertheless challenges the application of the method and asserts that the method actually used is an unspecified method. Attorneys might refer to this situation as lack of scienter.
2. The taxpayer knows that it might be using a transfer pricing method that is at variance with a specified method, but believes nonetheless that it uses a specified method. The IRS challenges application of the taxpayer’s method and asserts that the method used is an unspecified method. Attorneys might refer to this situation as scienter.

The difference between these two examples is the taxpayer’s knowledge of the activities and the consequences of its actions. In both cases, the IRS has determined that the taxpayer has deviated from an arm’s-length analysis and has distorted income. If the taxpayer files the tax return documentation statement with the tax return, the taxpayer may have complied with the unspecified method requirements, and thus the penalty might not apply. If the taxpayer does not file the tax return documentation statement with the tax return, the taxpayer will not have complied with the unspecified method requirements, and the penalty would apply.

Referring to the first example, the taxpayer that had knowledge of its acts will be able to escape from the penalty, but the ignorant taxpayer could not. Disclosure of the unspecified method may greatly increase the likelihood of an audit. Nevertheless, a taxpayer that believes it will be audited may be better off claiming an unspecified method.

CONCLUSION

Taxpayers that fail to prepare for the contemporaneous documentation rules are likely to find themselves unable to use these ameliorative provisions. Hence, the taxpayer may find that the transfer penalties are fully applicable.

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Advanced Transfer Pricing Issues
PROPOSALS FOR REVISING THE TRANSFER PRICING AUDIT STRUCTURE

The IRS is now in the process of modifying its transfer pricing procedures because the regulations have proved to be deficient in several respects, including documentation, examination procedures, and methodologies. These modifications will be taking place through revised audit procedures as well as possibly through changes to the regulations themselves.

USING DATA SOURCES

There are many occasions in which the IRS fails to seek, obtain, or utilize potential data sources. In short, we suggested to the IRS that there may be occasions in which Information Document Requests (IDRs) are too narrowly focused. These are two situations in which the IRS may benefit from expanding the IDR process.

International Merger Example

Consider, as an example, the situation of an IRS international examiner and the transfer pricing economist seeking information about an international merger. The two entities had been independent, but the U.S. entity and a foreign subsidiary face intercompany transfer concerns for the first time because of this merger. The merger that is under review by the IRS had previously been subject to the Hart Scott Rodino (HSR) premerger notification requirements with the Department of Justice (DOJ) and the Federal Trade Commission (FTC).1

It would be in the interests of the IRS to seek, obtain, and utilize these HSR premerger filings. The filings should provide the international examiner and the transfer pricing economist with information that should be quite useful in the transfer

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pricing context, especially regarding industry segments and competitors. In this regard, the international examiner and the transfer pricing economist should be able to interpret the importance of second request filings, the investigation process, and third-party involvement in the HSR process.

**Engineering Economy Example**

The international examiner is dependent on receiving and utilizing engineering data under several scenarios (see the following section, “Cost Issues, Excess Capacity, and Cost Structures Overseas,” for one such example). We suggested that the transfer pricing economist be involved in the interpretation of engineering data in coordination with the needs of the international examiner until the transfer pricing coordinator(s) serve this role.

In our view, having a transfer pricing coordinator would be beneficial to the IRS because the transfer pricing coordinator could better identify or confirm data sources that should exist before the IRS makes the effort to seek, obtain, and utilize these data sources. The transfer pricing coordinator and other high-level transfer pricing personnel should benefit from education and cross-training that would bring these untapped data sources to light.

**Divisional Tax Accounting and Intracompany Transfer Pricing**

Tax considerations are the central focus of the transfer pricing regulations, to the exclusion of the business considerations other than taxation that impact transfer pricing. As such, we suggested that the transfer pricing regulations take into account such business facets as division and profit center accounting, autonomous transactions, vertical integration, and the like.²

The fact of the matter is that businesses may be making transfer pricing decisions for other reasons than worldwide tax minimization. Tax issues, although clearly important, have declined in comparative importance as tax rates have declined during the 1990s and beyond.

For example, the transfer pricing regulations fail to recognize that many multinational businesses operate on a two-tier system: an official intercompany transfer price and an informal intracompany transfer pricing system. This two-tier system occurs most often in the context of work-in-process goods because there is often no true market for these goods.

The transfer pricing regulations fail to address intermediate goods, such as work-in-process inventories. At the present time, the taxpayers and the IRS have been reticent in seeking and applying this intracompany data because the transfer pricing regulations do not address this product area.

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COST ISSUES, EXCESS CAPACITY, AND COST STRUCTURES OVERSEAS

Many multinational businesses transfer their products among affiliated enterprises by using a full standard cost system or by using a full actual cost system. As a practical matter, manufacturers both inside and outside the United States have to address excess production capacity issues from a cost accounting perspective, for addressing allocation and apportionment considerations, and for addressing transfer pricing considerations. The treatment of excess capacity is likely to be an allocation and apportionment issue under Regulation Section 1.861-8 when the excess capacity takes place within the United States and as a transfer pricing issue when excess capacity takes place in a foreign facility, thus creating nonparallel treatment.

Our concern is that such intercompany transfers produce a significant level of contemporaneous documentation, but the IRS rarely takes the opportunity to analyze this data, and, as a result, the data is ignored or lost. Consider the following two examples:

EXAMPLE

X Corporation is a manufacturer in Country X. X’s factory has the capacity of producing 10,000 widgets per year. X produces and sells 4,000 units for sale in the United States and produces and sells 4,000 units for sale in Country X during year 1. The remaining 2,000 units are not produced and became excess capacity for year 1. The variable cost of production is $1,000 per unit. Overhead is $5 million. X Corporation sells the widgets to its U.S. affiliate for $1,800 each. The U.S. affiliate uses extensive marketing intangibles and sells the widgets to ultimate customers for $2,000 each.

Assume that X Corporation treats excess capacity costs as attributable to X’s exports under local law and pursuant to the transfer pricing rules of Country X. Exports to the United States would bear 60% of the overhead costs (4,000 export units plus 2,000 excess capacity units divided by 10,000 units) or $3 million (60% × $5 million). The $3 million would be divided by the 4,000 export units, or $750 per unit. Total costs would be $1,750 ($1,000 in variable costs plus $750 for overhead.) Corporation X would show profits of $200,000 ($50 × 4,000 units) for its U.S sales.

In contrast, domestic sales in Country X would bear 40% of the overhead costs (4,000 domestic units divided by 10,000 units) or $2 million (40% × $5 million). The $2 million would be divided by the 4,000 domestic units, or $500 per unit. Total costs would then be $1,500 ($1,000 in variable costs plus $500 for overhead.) Cor-
poration X would then show profits of $1.2 million ($300 × 4,000 units) for its domestic sales, assuming the $1,800 price.

The international examiner reviews the $1,800 intercompany transfer, the marketing intangibles of the U.S. affiliate, and the sale to the ultimate customer of $2,000. The U.S. corporate tax director exclaims, “The entire profit is $250 per unit, of which $200 is in the United States. Do you want blood from a stone?” The international examiner views the transaction as a resale transaction and elects not to pursue the matter further in light of the company’s SIC code. The U.S tax director makes no mention of the cost shift overseas, and in fact the U.S. tax director may not know of that cost shift.

EXAMPLE POSTSCRIPT

It is our view that the IRS does not have the facility to pay adequate attention to overseas cost structures. There are two reasons for this gap:

1. The transfer pricing economist, being trained in marginal costing, is well suited to analyze the business’s cost system, and the transfer pricing economist is well equipped to examine a crucial component of the cost system—excess production capacity. Nevertheless, the transfer pricing economist rarely, if ever, has the opportunity to delve into the specifics of the business cost system under review. In addition, the transfer pricing economist for the most part lacks the skill set to address allocation and apportionment issues under Regulation Section 1.861-8.
2. International examiners and attorneys lack the skill set to address cost systems or excess production capacity. Nevertheless, international examiners have the facility and skill set to address allocation and apportionment issues under Regulation Section 1.861-8. As a practical matter, the international examiner is unlikely to have the opportunity to address excess capacity issues because these issues are likely to be buried within the company’s cost accounting system.

ADVANCE PRICING AGREEMENTS

It is our belief that the central transfer pricing issues for taxpayers and the IRS is foregone opportunities on the part of both parties as well as with their foreign counterparts.

Unilateral, Bilateral, and Multinational Agreements

We support the APA process, whether unilateral, bilateral, or multilateral. It is our belief that the acceleration of the APA process should be a goal of the United States as well as a goal of U.S. taxpayers. The best way to achieve this goal is through increased use of e-mail and Internet technologies to access and review databases of the business originating from disparate locations.

It is our belief that the central transfer pricing issues for taxpayers and the IRS is foregone opportunities on the part of both parties as well as with their foreign counterparts. We support the advance pricing agreement process, whether unilateral, bilateral, or multilateral.

Competent Authority Considerations

We believe that the competent authority process is too slow to be effective, whether on the part of the taxpayer in dealing with the IRS or with the IRS in dealing with the IRS’s foreign counterparts. We favor a change in the competent authority process and in the bilateral APA process that would bring the following parties to the table:

- The taxpayer
- The IRS
- The foreign affiliate of the U.S. taxpayer
- Tax authorities of the foreign government

We recognize the IRS’s position that it views the competent authority process as being government to government and that taxpayers are being told to “butt out.” In our view, many taxpayers have lost respect for the competent authority process because of the IRS’s viewpoint and the slowness of the process itself.

GRAY MARKET CONSIDERATIONS

Gray market sales begin when a manufacturer sells its products to retailers in different locations. The sales price differs sharply from one location to another. A purchaser buys the product from the retailer at the lower cost then available at the low-cost jurisdiction. The purchaser uses this pricing differential by reselling the goods into a higher-priced jurisdiction at a higher price. This price is still lower than the price charged by the manufacturer/seller in that second market.

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All too often, IRS examiners, upon viewing a scheme or device that seems unusual to them, suspect that the taxpayer has concocted a device that has as its primary purpose the saving of taxes. The facts are often otherwise. In the gray market situation, these schemes or devices may be designed for nontax purposes, such as a device to siphon off the manufacturer’s profits.

Misdirection of sales—whether inadvertent or not—becomes crucial. These schemes may have tax ramifications that the IRS is likely to miss because the IRS is looking elsewhere. Here the examiner is reviewing the manufacturer and the seller in a quest for transfer pricing adjustments, but the purchaser who resold the goods unbeknown to the manufacturer caused the potential adjustments.

**EXAMPLE**

V Corporation, headquartered in country V, produces kimonos in country V and sells kimonos in two countries, Country V and in Country J, for $25 each. In addition, V Corporation sells 200,000 kimonos in the United States, of which 100,000 are sold to Y Corporation, a U.S. company, at a price of $9 each, or $900,000 in total. V Corporation and Y Corporation are totally independent.

Y Corporation exports the kimonos to its subsidiary J Prime in Country J, incurring a shipping charge of $1 per unit for the kimonos, or $100,000 in total shipping charges. Y Corporation sells the kimonos for $11 each, reflecting gross sales of $1.1 million, costs of $9 each or $900,000, shipping expenses of $1 per unit or $100,000, and earns a profit of $1 per unit or $100,000.

J Prime then resells the kimonos for $20 each in Country J, thus undercutting V Corporation’s sales price of $25 in country J. J Prime’s revenue is $2 million, 100,000 kimonos × $20 each. J Prime is a discount operation and has no intangibles. The gross income from the transaction is $2 million. Net income to J Prime is $2 million minus the $900,000 purchase price for the kimonos and $100,000 for the shipping of the kimonos, or a net of $1 million. The U.S. portion of the profit is $100,000, one-tenth of the total.

The international examiner examines the Form 5472 for V Corporation and the Form 5471 for Y Corporation to determine whether these businesses are related parties. The analysis is inconclusive. Nevertheless, the international examiner believes that V Corporation and Y Corporation might be affiliates and examines whether the initial sales price of the kimonos of $9 is at arm’s length. The international examiner compares sales to V Corporation and sales to others in the United States and concludes that the transactions with Corporation V are in fact at arm’s length.

The international examiner undertakes a SIC code analysis and establishes that Y Corporation earns a comparable return on investment of its U.S. activities. As such, the international examiner proposes no adjustment against Y Corporation.

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SUGGESTIONS

We suggest that the underlying purpose of Y Corporation’s activities was to develop a gray market structure against V Corporation, to take advantage of V Corporation’s high profitability in Country J. That having been said, there is a transfer pricing issue. The U.S. activities of the Y Corporation group are only one-tenth of the total profits, and a significant portion of that profit is in purchasing the kimonos in the United States. We note that the U.S. transfer pricing regulations recognize marketing intangibles, but these regulations do not take purchasing intangibles into account.

CORPORATE GOALS AND STRUCTURE

International examiners view the decision-making process of a worldwide corporation as a monolith, seeking to maximize after-tax returns on investment. All too often, this perception is not correct, as the worldwide business tends to have divergent goals, including:

- Executives may be paid and evaluated based on a defined segment of the overall business. Each such executive normally would seek to maximize his or her income and profits, which may differ from the maximization goals of the entire business.
- Pricing adjustments tend to be made after the fact rather than being contemporaneous with the events that would precipitate change. Obsolete data can change the pricing method being selected.

DETERMINING WHO OWNS THE INTANGIBLES

Transfer pricing professionals, whether within the IRS or private practitioners, expend considerable effort in determining whether a particular intangible is owned by a U.S. business rather than owned by its foreign affiliates. These professionals most typically undertake this transfer pricing analysis with a view toward ascertaining the applicable arm’s-length licensing rate. These transfer pricing professionals, however, expend much less effort in ascertaining whether the business owners or the business owns the intangibles. The intangibles may initially begin with the business owner, and these intangibles remain with the business owner, never having been transferred to the business itself.

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When Does the Intangible Issue Arise?

This intangible ownership issue most typically arises in either of two contexts:

1. Capital gains or reorganization context, in the event of a sale or disposition of the business
2. Estate planning

As a practical matter, the intangible ownership issue infrequently arises in the transfer pricing context. The failure of the IRS to actively address this intangible ownership issue in the transfer pricing context has become more serious in light of taxpayer victories in *Martin Ice Cream v. Commissioner* ¹¹ and *Norwalk v. Commissioner*. ¹²

Case Law

In *Martin Ice Cream*, the father (a shareholder) had extensive marketing contacts and marketing expertise, which he used to introduce ice cream to supermarkets. The Tax Court recognized marketing contacts and marketing expertise as being intangible assets. The Tax Court concluded these marketing rights were the property of the father and did not belong to the corporation.

In *Norwalk*, two accountants set up an accounting corporation, which had employment agreements, a covenant not to compete, and protection over client records. The agreements terminated and the corporation liquidated. The IRS asserted that the market-based intangibles were assets of the corporation, subject to tax under Section 336. The Tax Court held that these assets were owned by the shareholders themselves and that no tax was applicable.

Three Scenarios

Consider three scenarios for intangible ownership in the context of potential transfer pricing issues:

1. The IRS is likely to have the requisite data in two of the four basic fact patterns to address transfer pricing concerns.
2. One basic fact pattern indicates that a licensing structure would unlikely be used because the structure would be disadvantageous to the business and to the business owner.
3. One basic fact pattern indicates that licensing would be advantageous to the business and to the business owner, but that the IRS is ill prepared to address that particular situation.

As we shall see, the latter situation, in which the IRS is ill prepared, is most plentiful, especially as tax advisors are increasingly advocating licensing structures in light of *Martin Ice Cream* and *Norwalk*.

How Taxpayers Would Structure Licensing Arrangements

In the first scenario, the business owner is a U.S. resident, the business is located in the United States, and the business is profit making. Here it is in the interest of the business owner and the business to charge for the intangibles through a license arrangement. The taxpayer is siphoning off a portion of the business’s profits in lieu of declaring and paying dividends.

This licensing transaction in the first scenario is a wholly domestic matter. In fact, the impetus for these transactions is to achieve state tax savings when the business owner moves to a low or no state income tax jurisdiction. As a practical matter, the IRS is unlikely to address the licensing matter from the transfer pricing viewpoint because the IRS views transfer pricing as an international issue. At present, the only bar to imposing excessive royalty amounts is the risk to the business owner that the IRS will view part or all of the payments as imputed dividends.

Additional Licensing Scenarios

In the second scenario, the business is incurring persistent losses. Licensing would cause the business owner to reflect personal licensing income despite a business’s deficit in earning and profits. In that situation, it would be in the business owner’s interest not to license the intangibles. In addition, the value of the marketing intangibles would be open to question.

In the third scenario, the business owner is located in the United States and the business is located outside the United States. The business owner and the business, operating together, would consider the business’s deductibility of license fees, withholding rates, effectively connected status of the business owner, and taxability of licensing amounts accrued or received in the United States, after considering foreign tax credit and similar issues. In any event, the IRS should have this information, including transfer pricing information, through the filing of Form 5471.

LIFE-CYCLE BUSINESS ANALYSIS

The transfer pricing regulations fail to address several transfer pricing issues, among them being the life cycle of an ongoing business.13 As transfer pricing practitioners, we have seen that international examiners and transfer pricing economists have different approaches to the business life cycle:

- We have found that international examiners, for the most part, are not attuned to business cycle analysis. The international examiner tends to ignore life-cycle analysis because, quite simply, the transfer pricing regulations do not directly address life-cycle analysis.

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In contrast, transfer pricing economists within the IRS have a different skill set, making them, for the most part, quite familiar with this business cycle analysis. In essence, the transfer pricing economist treats business cycle analysis as a given. As such, because of the disparity between the approaches of the international examiner and the transfer pricing economist, the taxpayer desperately needs the attention of the transfer pricing economist.

Life-Cycle Analysis Under IRS Audit

Life-cycle analysis reflects activities that are dynamic and continuous, and have many gradations, such as the following:

- Start-up
- Growth
- Maturity
- Decline
- Termination

Transfer pricing, by its nature, comes to be an issue in the middle three life-cycle phases. The third of these three life-cycle phases, the decline phase, becomes problematic in the transfer pricing context because the international examiner relies on (or, from our standpoint, overrelies on) the prior years’ database.

Declining Businesses and the CRT Example

Consider, for example, a business that produces cathode ray tube (CRT) computer monitors. This CRT industry is declining because flat screen monitors are becoming increasingly prevalent. This decline in CRTs means increased emphasis on engineering and production, as efficiency becomes the byword. Prior data is no longer relevant in ascertaining subsequent year results, but the international examiner, not being attuned to life-cycle analysis, chooses to ignores this issue.

Overreliance on External Data

Over the past decade, transfer pricing analysis has become increasingly dependent on external data. Both taxpayers and the IRS have viewed the CPM as the transfer pricing method of choice. As a result, both taxpayers and the IRS expend considerable time and effort in including or excluding corporate data that could or could not be treated as comparables.

This quest for comparables has become increasingly suspect. The data being sought by taxpayers and the IRS is accounting and financial data, as opposed to tax data. This accounting data came under increasing scrutiny after the Enron–Andersen debacle for three reasons:

1. The populace and the financial community’s increasing distrust of the accounting rules prescribed by the Securities and Exchange Commission (SEC) and by the Financial Accounting Standards Board (FASB)
The populace and the financial community’s increasing challenge to the independence of the financial auditors

The populace and the financial community’s increasing distrust of the data and the financial statements being presented, in part because of document destruction

As a result of these events external to the transfer pricing process, the taxpayer or the IRS that relies on comparables is on dangerous ground. It has now become much easier for the transfer pricing litigator to challenge the comparables presented by the opposition. The transfer pricing regulations refer to the reliability of data, and this issue itself may be the issue in transfer pricing litigation.

It is our view that events external to the transfer pricing process will impact forum selection and taxpayer challenges to the IRS’s comparables. More taxpayers may find refuge with the District Court and avoid both the Tax Court and the Claims Court to secure their right to trial by jury, to better challenge the comparables being presented by the IRS as part of the comparable profits method.14 These events are part of the fallout of the recent accounting and financial failures, to be sure, but we suggest the IRS return to the traditional transfer pricing methodologies or develop new methodologies such as the “comparison of functions employed” discussed later in this analysis.

DEPENDENCE ON SIC CODE ANALYSIS

All too often, the selection of an SIC for a business is often made by the lowest functionary of that business, the person who knows least about the current business or the future plans of the business. Nonetheless, the international examiner may seize upon the SIC code and force the business into the mold of that SIC code to secure a ready transfer pricing comparable.15

SIC Issues

The following SIC code issues are likely to arise:

- The SIC code being selected by the taxpayer may not be correct.
- The SIC code may change over time, making the original SIC code no longer relevant.
- The business could be better reflected by having several SIC codes.

We believe that the IRS should undertake an initial review of the SIC code being selected by the taxpayer. Furthermore, we find that both taxpayers and the IRS

would benefit from establishing parameters for having more than one SIC code. We suggest that such parameters be analogous to the segmental analysis under Section 1.6038-3(c)\textsuperscript{16} or to high-profit segments under Section 1.6038-3(c)(6),\textsuperscript{17} addressing return on assets.

**Difficulties Caused By the Comparable Profits Method**

The CPM forces each taxpayer to be categorized into a narrow category such as an SIC code. The examiner partakes in this process. Both the taxpayer and the examiner spend much of their time questing for comparables. The company and the comparables may rely on questionable codification, possibly erroneous numbers, and the possibility that the comparables may be erroneous. We agree that the comparable profits method is the method of last resort for transfer pricing purposes.

Each business believes that its business is unique and special. The quest for comparables is antithetical with that belief. A better result would be to examine each segment or division of a business to determine the profit split. This process requires staffing, and we suggest that the profit split analysis be first developed by the taxpayer in each instance.

**Jingoism Can Shift Transfer Pricing Results**

The CPM assumes that the data used would be neutral between jurisdictions, that U.S. manufacturers could be equated with foreign manufacturers, and that U.S. resellers could be equated with foreign manufacturers. In fact, a multinational organization has a tendency to shift profits to the home country. There are two facets of this tendency:

1. *Pure patriotism.* Decisions made independent of the tax effects
2. *Tax decision making.* Taking the cost of withholding into account

The transfer pricing regulations have not come to grips with the jingoism shift. The shift can be significant if, for example, all manufacturers are located in one country and the retailers are located in a different country. Return for a moment to the kimono example.

Assume that all of the kimonos are produced outside the United States, that very limited profits are left in the United States, and that virtually all of the profits are located in the country of the manufacturer. These results will be distortive to a new U.S. manufacturer of kimonos. The same situation could well occur in any industry when most of the manufacturers are located overseas except for the tested party, or when all of the manufacturers are located in the United States except for a foreign-located tested party.

It is our view that many international examiners give short shrift to the best method process, thus ignoring functional analysis and risk in particular. We believe that the CPM is not automatically the best transfer pricing method. Instead, the traditional transfer pricing methods may be more fully applicable.

All too often, it appears to us that the CPM is chosen because it is easier for the international examiner to apply it solely because of the availability of the SIC code database. As litigators, it is our view that disparity between the regulations as to best method provisions and present audit techniques leads to increased vulnerability on the part of the IRS.

"COMPARISON OF FUNCTIONS EMPLOYED" METHODOLOGY

We believe the Regulations approached the creation of viable profit split regulations at the time that the Treasury promulgated the former temporary transfer pricing regulations. Nevertheless, the Regulations stepped back from these particular profit split provisions. The Treasury did not carry these provisions forward when the Treasury promulgated the final transfer pricing regulations, thus creating a gap in the need to have viable profit split regulations.

The profit split methods, as now constituted, are difficult to perform and are rarely applied. Nevertheless, we continue to believe in the potential efficacy of profit split methods. In response to that need for viable profit split transfer pricing methodologies, we are proposing one of the most important potential transfer pricing methodologies—a profit split based on a comparison of the functions being performed, which we term the functions employed comparison (FEC). This transfer pricing method could permit the taxpayer and the IRS to develop an arm’s-length price that is wholly independent of external data sources.

There would be three steps in computing the FEC method:

1. Compute the composite rate of return.
2. Sever transfer pricing transactions from nontransfer transactions.
3. Make economic adjustments.

We believe the FEC method could be effectuated by the IRS under audit, with the first two steps being effectuated by international examiners plus an assist from cost accountants. Transfer pricing economists would undertake the final step. We further

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suggest that the IRS develop a new form that could be used to better effectuate the FEC method.

**Begin with Composite Return on Investment**

The first step in applying the functions employed comparison, at the outset, would be to apportion total composite income or profits, determined on a net basis, using a constant rate of return concept. This income would be apportioned based on total assets where these amounts are determined on a worldwide basis.

\[
\frac{IR}{RW} = \frac{IA}{RA} = \frac{IB}{RB}
\]

A and B are portions of the worldwide business, W is income and assets determined on a worldwide business, I is income, and R is the amount of assets. This inquiry does not end the transfer pricing process, but instead would be the beginning point. Adjustments to this process take place later.

Assume that the enterprise has activities in two locations: Location A and Location B. Assets are $2 billion in Location A and $4 billion in Location B, or $6 billion in total, and overall profits for the enterprise are $900 million. It is then appropriate to apportion the $900 million profit to $300 million in Location A and $600 million in Location B to equate the returns of each location (e.g., a 15% return at each location)

The formula would be reflected as follows:

<table>
<thead>
<tr>
<th>Worldwide</th>
<th>Location A</th>
<th>Location B</th>
<th>Return on Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>900 million</td>
<td>300 million</td>
<td>600 million</td>
<td>15%</td>
</tr>
<tr>
<td>6 billion</td>
<td>2 billion</td>
<td>4 billion</td>
<td></td>
</tr>
</tbody>
</table>

**Severing Transfer Pricing Transactions from Nontransfer Transactions**

The first step in the functions employed method implicitly treats transfer pricing transactions in the same manner as transactions that are not subject to the transfer pricing provisions. The second step in the functions employed method would be to sever the transfer pricing transactions from transactions that are independent from the scope of the transfer pricing regulations. Economic adjustments would then provide the third step.

The concept underlying the severing process is that a business has limited flexibility to arrange nontransfer transactions. In contrast, the business has extensive versatility in adjusting, or attempting to adjust, transactions that are subject to the transfer pricing regulations.

This second step in the functions employed method has three substeps:

1. The IRS (or the taxpayer) would sever for tax accounting purposes the assets used for transfer pricing purposes from assets that are used for other than transfer pricing purposes.
2. The IRS (or the taxpayer) would then divide dual-use assets on a pro rata basis.
3. The IRS (or the taxpayer) would then sever for tax accounting purposes the income for transfer pricing purposes from the income for other than transfer pricing purposes. Total income or profits is determined on a deemed basis, based on the first step of the analysis; income not subject to transfer pricing is the actual amount; income subject to transfer pricing is the residual amount.

Return to our example in which Location A has assets of $2 billion and is deemed to have income of $300 million. In this scenario, assets subject to transfer pricing are $1 billion and assets not subject to transfer pricing are $1 billion, taking dual-use assets into account. Now let us assume that income not subject to transfer pricing is $200 million. This amount would be determined on the actual records of the business. The income subject to transfer pricing analysis is the deemed total income of $300 million, less the income of transactions not subject to transfer pricing of $200 million, or $100 million in total.

The return on investment data for Location A would appear as follows:

<table>
<thead>
<tr>
<th>Transactions Not Subject to Transfer Pricing</th>
<th>Transactions Subject to Transfer Pricing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>$200 million</td>
<td>$100 million</td>
</tr>
<tr>
<td>Assets</td>
<td>$1 billion</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Return</td>
<td>20%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Now we turn to our example in which Location B has assets of $4 billion and is deemed to have income of $600 million. In this scenario, assets subject to transfer pricing are $1 billion, and assets not subject to transfer pricing are $3 billion, taking dual-use assets into account. Now let us assume that income not subject to transfer pricing is $300 million. This amount would be determined on the actual records of the business. The income subject to transfer pricing analysis is the deemed total income of $600 million, less the income of transactions not subject to transfer pricing of $300 million, or $300 million in total.

The return on investment data for Location B would appear as follows:

<table>
<thead>
<tr>
<th>Transactions Not Subject to Transfer Pricing</th>
<th>Transactions Subject to Transfer Pricing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>$300 million</td>
<td>$300 million</td>
</tr>
<tr>
<td>Assets</td>
<td>$3 billion</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Return</td>
<td>10%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Recombining the Transfer Pricing Transactions

<table>
<thead>
<tr>
<th></th>
<th>Location A</th>
<th>Location B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>$100 million</td>
<td>$300 million</td>
<td>$400 million</td>
</tr>
<tr>
<td>Assets</td>
<td>$1 billion</td>
<td>$1 billion</td>
<td>$2 billion</td>
</tr>
<tr>
<td>Return</td>
<td>10%</td>
<td>30%</td>
<td>20%</td>
</tr>
</tbody>
</table>
Making Economic Adjustments

The final step in the FEC transfer pricing method would be to make economic adjustments, including accounts receivable, accounts payable, inventories, risks, currency adjustments, life-cycle analysis, market intangibles, technology licensing rates, and so forth. Here, the transfer pricing economist would begin with the differences in rate of return in Location A and in Location B and would contrast functions and risks between these two locations. Finally, the transfer pricing economist should ascertain whether the functions employed method is in fact the best transfer pricing method in this situation.

USING TOTAL OPERATING EXPENSES

We suggest the total operating expense method as an alternative to the return on assets method. Under this approach, total operating expenses for each branch, segment, division, or subsidiary would be determined. These total operating expense amounts would be allocated and would serve as the denominator of an apportionment fraction. The numerator of the fraction would be the total operating expenses of that branch, segment, division, or subsidiary.

Total operating expenses are the denominator of the Berry ratio, gross profit divided by total operating expenses. The second step in this process would be to sever transfer pricing transactions from nontransfer pricing transactions. The third step in this process would be to make economic adjustments.

Gross Operating Expense Computations

The first step in the transfer pricing process would be to combine the gross operating expense amounts to the branches, segments, divisions, or subsidiaries. Assume that a corporation has two divisions, Division C and Division D.

\[
\frac{\text{Division C Profit}}{\text{C Operating Expenses}} + \frac{\text{Division D Profit}}{\text{D Operating Expenses}} + \frac{\text{Total Profit}}{\text{Total Operating Expenses}}
\]

\[
\frac{200,000}{500,000} + \frac{800,000}{1,500,000} + \frac{1,000,000}{2,000,000}
\]

Severing Nontransfer Pricing Transactions from Transfer Pricing Transactions

The second step in the gross operating expense computation is to sever nontransfer pricing transactions from transfer pricing transactions. Consider the results for Division C and for Division D:

---

Recombining the Transfer Pricing Transactions

<table>
<thead>
<tr>
<th></th>
<th>Division C</th>
<th>Division D</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>100,000</td>
<td>200,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>200,000</td>
<td>500,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Ratio</td>
<td>50%</td>
<td>40%</td>
<td></td>
</tr>
</tbody>
</table>

Economic Analysis

The final step in the operating expense transfer pricing method would be to make economic adjustments, including accounts receivable, accounts payable, inventories, risks, currency adjustments, life-cycle analysis, market intangibles, technology licensing rates, and so forth. Here, the transfer pricing economist would begin with the difference in income in operating expenses of 50 percent in Division C in contrast with 40 percent in Division D. Finally, the transfer pricing economist should ascertain whether the operating expense method is in fact the best transfer pricing method in this situation.

TAX MALPRACTICE ATTORNEY AS YOUR ALLY

As IRS officials, you may find that you may have an unlikely ally—the plaintiff’s tax malpractice litigator in a malpractice claim against directors, officers, or tax professionals. The plaintiff’s tax malpractice litigator may be attacking the same practices that take place in a business as would you, especially if the business or its tax advisors have gone amuck. In essence, in some situations, the plaintiff’s tax malpractice litigator can serve as an adjunct to the IRS, just as a professional investigator serves as an adjunct to the police in securing data that might be unavailable to the IRS.

DEVELOPING THE STANDARD INITIAL TRANSFER PRICING INFORMATION DOCUMENT REQUEST

Audits have been decreasing as a percentage of taxpayer returns during the past few years because of IRS staffing shortages. These shortages may have led to a kinder, gentler IRS but have severely challenged the veracity of America’s taxing system. Charles Rossotti, Commissioner of Internal Revenue, made steps to fill this gap.

It is our belief that overall tax compliance would benefit from meeting the IRS staffing needs and from the IRS agents’ greater use of information document requests. Such a need is for a standard information document request in the transfer pricing context.

We have prepared such a standard transfer pricing information document request for the IRS as part of our presentation to IRS officials. This was part of our presentation concerning “documentation, examination procedures, and methodologies” praised by Mr. Rossotti and by Treasury Secretary Paul O’Neill. In preparing these standard transfer pricing information document requests for the IRS, as practitioners we are mindful of the time and effort in preparing and retaining such documentation.

Initial Transfer Pricing Information Document Request

The following provisions apply for Part I of the Initial Transfer Pricing Information Document Request.

**Profit and Loss Statement**  A profit and loss statement includes records that pertain to profit and loss. These records requested herein reflect the following:

- Profit or loss statements of the taxpayer and all related parties (the related-party group) that meet required parameters
- Profit or loss statements of the taxpayer and all related parties (the related-party group) attributable to U.S.-connected products or services that meet required parameters

The definition of profit and loss statement is taken from Treasury Regulation Section 1.6038A-3(c)(2)(ii). This definition of a profit and loss statement is broader for the Initial Transfer Pricing Information Document Request than it is for the Treasury Regulation Section 1.6038A-3(c)(2)(ii) definition. This broader definition enables the IRS to determine whether the taxpayer is complying with other facets of Section 6038A, Section 482, and Section 6662. Treasury Regulation Section 1.6038A-3(c)(2)(ii) seeks records that are material. The Initial Transfer Pricing Information Document Request treats these documents as tentative material in the first instance, pending future examination by the IRS.

**Related Party**  A related party meets one of three definitions:

1. A related party is a party that is a direct or indirect shareholder of the taxpayer.
2. A related party is a party that is a direct or indirect subsidiary of the taxpayer.
3. A related party is a party that is acting in concert with the taxpayer as otherwise as defined under Section 267(b), Section 707(b)(1), or Section 482.

A party is to be treated as a related party based on 25 percent direct or indirect common ownership. Corporations filing a consolidated federal tax return can elect to treat the consolidated tax return as one entity. This definition of related party is taken from Treasury Regulation Section 1.6038A-1(d). The Initial Transfer Pricing Information Document Request affirmatively addresses the 25 percent threshold in Treasury Regulation Section 1.6038A-1(d). The definition of a related party is broader in the Initial Transfer Pricing Information Document Request so as to test whether the taxpayer is complying with the requirements of Treasury Regulation Section 1.6038A, Section 482 and Section 6662.

**Related-Party Group**  A related-party group encompasses the taxpayer and all related parties, whether foreign or domestic. This definition of related-party group is taken from Treasury Regulation Section 1.6038A-3(c)(2)(ii), which deals with profit and loss statements, and with Treasury Regulation Section 1.6038A-1(d), which deals with the definition of related-party group. This definition of related-party group is taken from Treasury Regulation Section 1.6038A-3(c)(4), the existing records test. Treasury Regulation Section 1.6038A-3(c)(4) determines the materiality of the records by their presence of these records.

**U.S.-Connected Products or Services**  U.S.-connected products or services means products or services that are imported to or exported from the United States by transfers by the taxpayer and any of its related parties. For this purpose, exports are added to each other and are not subtracted. The definition of U.S.-connected products or services is taken from Treasury Regulation Section 1.6038A-3(c)(7)(i). The Initial Transfer Pricing Information Document Request terminology is somewhat broader than the comparable term in the regulations. The Initial Transfer Pricing Information Document Request refers to all related parties, but Treasury Regulation Section 1.6038A-3(c)(7)(i) applies only to “foreign” related parties.

**Application of “U.S.-Connected Products or Services”**  The taxpayer is to make the following adjustments in determining U.S.-connected products or services:

- Gross up all licensing amounts to reflect the rights or assets giving rise to the licensing amounts.
- Gross up all lease amounts to reflect the assets giving rise to the leasing amounts.

Licensing and leasing are often determined on a net basis. Information requested here is designed to better equate licensing and leasing with the sale of goods.

**Industry Segment**  Industry segment means a segment of the related-party group’s combined operations that is engaged in providing a product or service, or a group of related products or services, where the product or service is directed primarily to cus-
tomers that are not members of the related-party group. The definition of *industry segment* is taken from Treasury Regulation Section 1.6038A-3(c)(7)(ii).

**Gross Revenues of an Industry Segment** Gross revenues of an industry segment means gross receipts in the nature of earning gross income that pertain to that segment. Gross revenues are taken into account before taking returns or allowances and are taken into account before determining the cost of goods sold or operating expenses. Gross revenues do not include borrowings, lendings, or the receipt of passive dividend income.

The definition of the *gross revenues of an industry segment* is taken from Treasury Regulation Section 1.6038A-3(c)(7)(ii).

**Worldwide Gross Revenues** Revenues of the taxpayer and the related-party group are to be determined reflecting worldwide gross revenues on an aggregate basis, whether the activities giving rise to the income are located within the United States or are located outside the United States.

**Operating Profit of the Industry Segment** The operating profit of the industry segment is the gross revenue of the industry segment minus all operating expenses of the industry segment. The following items cannot be added to or subtracted from operating profit:

- Revenue earned at the corporate level and not derived from operations of any industry segment, such as passive income
- General corporate expenses, except as allocated and apportioned under Treasury Regulation Section 1.861 et seq.
- Interest expense
- Domestic and foreign income taxes

This definition of *operating profit of the industry segment* is taken from Treasury Regulation Section 1.6038A-3(c)(7)(v).

**Worldwide Operating Profit** Worldwide operating profit of the taxpayer and the related-party group are to be determined reflecting worldwide operating profit on an aggregate basis, whether the activities giving rise to the income are located within the United States or are located outside the United States.

**Operating Expenses of the Industry Segment** Operating expenses as to an industry segment include all expenses of the segment, except for:

- General corporate expenses, except as allocated and apportioned under section 1.861 et seq.
- Interest expense
- Domestic and foreign income taxes
This definition of operating expenses of the industry segment is extracted from the term *operating expenses* in Treasury Regulation Section 1.6038A-3(c)(7)(v) but is not further defined in that section.

**Worldwide Operating Expenses**

Worldwide operating expenses of the taxpayer and the related-party group are to be determined reflecting worldwide operating expenses on an aggregate basis, whether the activities giving rise to the income are located within the United States or are located outside the United States.

**Return on Assets**

Return of assets is determined by dividing operating profit by identifiable assets that generated or gave rise to the income.

**Identifiable Assets of an Industry Segment**

Identifiable assets of an industry segment include tangible and intangible assets exclusively used by that industry segment and an allocation of all nonexclusive assets, using any reasonable and consistent method. This definition of *identifiable assets of an industry segment* is taken from Treasury Regulation Section 1.6038A-3(c)(7)(iv).

**Existing Records**

1. Specify the entity(ies) for which the taxpayer created or compiled a profit and loss statement and/or balance sheets for internal accounting purposes.
2. Specify the entity(ies) for which the taxpayer created or compiled a profit and loss statement and/or balance sheets for management purposes.
3. Specify the entity(ies) for which the taxpayer created or compiled a profit and loss statement and/or balance sheets for disclosure to shareholders.
4. Specify the entity(ies) for which the taxpayer created or compiled a profit and loss statement and/or balance sheets for disclosure to financial institutions.
5. Specify the entity(ies) for which the taxpayer created or compiled a profit and loss statement and/or balance sheets for disclosure to government agencies, whether foreign or domestic.
6. Specify the entity(ies) for which the taxpayer created or compiled a profit and loss statement and/or balance sheets for disclosure to any other persons.

The preceding requirements are directly taken from the existing records test in Treasury Regulation Section 1.6038A-3(c)(4), which speaks of profit and loss statements. Our position is that the IRS, having been authorized to acquire profit and loss statements, has the authority to obtain balance sheets for the same entity.

7. The taxpayer is to transmit all of the previously mentioned profit and loss statements and/or balance sheets to the international examiner within ___ days after receiving the IDR. The IRS will determine the number of days based on the facts and circumstances of the audit.

The following standards apply to profit and loss statements and balance sheets: As a general matter, when a taxable year is under review, the taxpayer must submit the
profit and loss statement, the balance sheet preceding the year being reviewed, and
the balance sheet after the year being reviewed. All such profit and loss statements
and balance sheets shall be submitted to the international examiner under this
provision:

- Whether the profit and loss statement and balance sheets are compiled or certi-
fied
- Whether the taxpayer applies uniform inventory capitalization
- Whether the taxpayer applies methods of amortization or depreciation
- Whether the taxpayer properly allocates and apportions expenses

Industry Segments

Preparation of Documents and the Supplying of Documents  For each such industrial seg-
ment, prepare and supply to the IRS the following statements for the year under
review, including:

- The profit and loss statement of the related-party group
- The balance sheet for the related-party group immediately preceding the year
  under review
- The balance sheet for the related-party group immediately after the year under
  review

Such statements are to be determined for each industry segment of the business
for which the amount of gross revenue earned by the related-party group from the
 provision of U.S. products or services within the industry segment is $25 million or
more for the taxable year.

Selecting Industrial Segments  The taxpayer is to provide the IRS with information
and documents in a manner that maximizes the number of industrial segments in
which U.S. products or services within the industry segment are $25 million or more
for the taxable year.

The taxpayer is to select industrial segments with due regard to its product lines,
products, models and related-party services.

The Initial Transfer Pricing Information Document Request is broader than the
Treasury Regulations in three respects:

1. Treasury Section 1.6038A-3(c)(5)(I)(B) limits the industrial segment analysis to
those industry segments that are 10 percent of the worldwide gross revenue of
the affiliated group’s combined industry segments,
2. Treasury Regulation Section 1.6038A-3(c)(6)(I)(B) speaks of $100 million seg-
ments under the high profit test,
3. The return of assets test under Treasury Regulation Section 1.6038A-3(c)(6)(ii)
addresses segments having worldwide operations of 15 percent or more and a
return on assets that is at least 200 percent of the return on assets earned by the
group in all industrial segments combined.
The Initial Transfer Pricing Information Document Request is designed in part to test whether the taxpayer meets the aforementioned segment requirements.

**Complying and Supplying Profit and Loss Statements and Balance Sheets**

The taxpayer is instructed to use the following rules for complying and supplying profit and loss statements and balance sheets for purposes of this analysis:

- The profit and loss statements must reflect the consolidated revenue and expense of all members of the related party group. Thus raw materials might be used by one party and finished goods might be sold by a different party, but all records are to be combined for this purpose.
- Financial statements are to be kept under U.S. accounting principles.
- Any reasonable method may be used to allocate the related-party groups’ worldwide costs to the revenues generated by the sales of those products or services. The taxpayer must provide an explanation of its accounting methods, including the manner in which costs are allocated.

The preceding requirements as to profit and loss statements are taken from Treasury Regulation Section 1.6038A-3(c)(2)(ii).

**Taxpayers Are to Complete the Following**

Specify the following amounts reflecting the entire business of the taxpayer and the related party group as a whole for the year under review:

1. Worldwide gross revenues
2. Worldwide operating expenses
3. Worldwide operating income
4. Worldwide gross assets

Specify the following information for each industrial segment for the year under review:

1. Gross revenues of the industrial segment, determined on a worldwide basis
2. Operating expenses of the industrial segment, determined on a worldwide basis
3. Operating income of the industrial segment, determined on a worldwide basis
4. Gross assets of the industrial segment, determined on a worldwide basis, based on identifiable assets

Amounts provided in items 1 through 4, together with amounts provided in the information requested as to worldwide activities of the taxpayer and related-party group provide the IRS with comparative data that may lead the international examiner to request subsequent Transfer Pricing Information Document Requests.

Specify the following information for the same industrial segment as to U.S.-connected products or services, determined on a worldwide basis, for the year under review:
5. Gross revenues of the industrial segment as to U.S.-connected products or services, determined on a worldwide basis
6. Operating expenses of the industrial segment as to U.S.-connected products or services, determined on a worldwide basis
7. Operating income of the industrial segment as to U.S.-connected products or services, determined on a worldwide basis
8. Gross assets of industrial segment as to U.S.-connected products or services, determined on a worldwide basis, based on identifiable assets

Amounts provided in items 5 through 8, together with amounts provided in items 1 though 4, provide the IRS with comparative data that may lead the international examiner to request subsequent Transfer Pricing Information Document Requests.

Specify the following information for the same industrial segment in the United States as to U.S.-connected products or services for the year under review:

9. Gross revenues of the industrial segment in the United States as to U.S.-connected products or services
10. Operating expenses of the industrial segment in the United States as to U.S.-connected products or services
11. Operating income of the industrial segment in the United States as to U.S.-connected products or services
12. Gross assets of the industrial segment in the United States as to U.S.-connected products or services, based on identifiable assets.

Amounts provided in items 9 through 12, together with amounts provided in items 5 though 8, provide the IRS with comparative data that may lead the international examiner to request subsequent Transfer Pricing Information Document Requests.

Signify whether you have retained all records pertaining to the transfer pricing documentation:

Yes ______
No ______

Treasury Regulation Section 1.6038A-3(g) requires the taxpayer to maintain records "so long as they may be relevant and material to determine the correct tax treatment.”

TRANSFER PRICING INFORMATION DOCUMENT REQUEST FOR ACQUISITIONS

Introduction

A person who is engaged in a merger, consolidation, or merger transaction (merger transaction) must generally report this merger transaction to the Federal Trade Com-
mission (FTC) and the Department of Justice (DOJ). The information pertaining to this merger transaction should generally be of interest to the IRS because information regarding the merger could address either or both of the following issues:

- The reorganization issues of taxability, basis, and carryover of attributes
- To assess whether, and to what extent, the merger transaction causes parties to undertake related-party transactions that are properly under IRS scrutiny under Section 482

Transfer pricing issues arise in two contexts in conjunction with FTC–DOJ reporting:

1. Erstwhile independent transactions between independent parties may well become related-party transactions, making these transactions subject to IRS scrutiny as a result of a merger.
2. The report filed with the FTC and DOJ in conjunction with a forthcoming merger may reveal existing related-party structures that the IRS previously had no occasion to observe.

This analysis examines the potential database and examination opportunities that the IRS now will have in the context of Section 482 transfer pricing as to merger transactions that are already subject to FTC–DOJ review. Robert Feinschreiber and Margaret Kent conducted this study at the request of the IRS. The Treasury and IRS previously asked Feinschreiber & Associates to further its review of the U.S. transfer pricing methodologies, databases, and audit techniques.

**Background**

Statutes require that each person that is subject to Section 7A of the Clayton Act, section 15 U.S.C. Section 18a, as added by Section 201 of the Hart Scott Rodino Antitrust Improvements Act of 1976, and rules promulgated thereunder must file a notification form with the FTC and DOJ. The form is termed Notification and Report Form for Certain Mergers and Acquisitions (Notification Form). The Notification Form is the appendix to 16 C.F.R. Part 803 and is FTC Form C4. The Notification Form is 15 pages in length and requires extensive specific attachments. Much of the information furnished to the FTC and the DOJ is through supplemental requests that the FTC and DOJ might make. This supplemental information can significantly add to information already provided through the Notification Form.

The acquiring party must pay a filing fee to the Federal Trade Commission, which can range from $45,000 to $280,000. It is our strong suspicion that the acquiring party, on discovering this fee, will not be complaining about the cost of obtaining an IRS ruling. We strongly suggest to the IRS that this phase of the transfer pricing information document request should be used only when the aggregate total amount of assets and voting stock to be held as a result of the acquisition are $50 million or more. Robert Feinschreiber and Margaret Kent suggested to the IRS that it additionally employ a standard transfer pricing information document request
that has different parameters from assets and voting stock, that of U.S.-connected goods or services.

**Objectives**

Robert Feinschreiber and Margaret Kent suggested to the IRS that it use a standard transfer pricing information document request form that would tie into the information provided by FTC Form C4. The international examiner would be the IRS person who would initiate this standard transfer pricing document request. We visualize that much of the information obtained by the international examiner would be funneled though to the transfer pricing economists, who would then utilize much of the information to make necessary economic adjustments as part of this audit review.

Robert Feinschreiber and Margaret Kent then suggested that the IRS employ such a standard transfer pricing information document request form to achieve this objective. This suggested standard form is published as part of this analysis. Robert Feinschreiber and Margaret Kent presented this analysis at the first instance to international examiners, transfer pricing economists, and IRS counsel for the southeast region on May 10, 2002, in Atlanta, Georgia.

**Examination of the Notification Form**

Many tax practitioners, including those engaged in a mergers and acquisitions tax practice, are unfamiliar with the FTC–DOJ Notification Form. Fewer merger and acquisitions tax practitioners are familiar with the transfer pricing implications of the FTC–DOJ filing. This portion of this chapter addresses the issues that tie in antitrust issues to transfer pricing tax issues. The Notification Form comprises eight detailed items together with some preliminary information about the filer and the certification by the filer of what is being included in the form.

The Notification Form delineates eight specific items as follows:

1. The person filing the form
2. Parties and the transaction
3. Specific issues affecting the transaction
4. Specific items relied on and filed
5. Detailed information reflecting the North American Industry Classification System—United States, 1997
6. Shareholders, holdings, and entities
7. Dollar revenues and geographic market information
8. Prior acquisitions

As we shall see, all eight items in the Notification Form have transfer pricing implications, but the fourth and fifth items in particular are specifically relevant to Section 482 transfer pricing. The Notification Form can apply to domestic–foreign mergers, to foreign–domestic mergers, to domestic–domestic mergers, and, in limited circumstances, to foreign–foreign mergers. As a result, the Notification Form is broader than the scope of both Form 5471 and Form 5472 together. Section 482
transfer pricing can encompass domestic–foreign mergers, foreign–domestic mergers, domestic–domestic mergers, and foreign–foreign mergers.

**Person Filing the Form**  
Item 1 in the Notification Form seeks the headquarters address of the party filing the form, which can be an acquiring person or an acquired person. The form can be filed on behalf of a foreign person pursuant to 16 C.F.R. 803.4 or on behalf of the ultimate parent entity pursuant to 16 C.F.R. 803.2(a).

Item 1(h) designates an individual located in the United States for the limited purpose of receiving issuance of a request for additional information or documents. Section 1.6038A(e)(1) and Treasury Regulation Section 1.6038A-5(b)(1) require the reporting corporation to specify an agent in the United States for tax purposes. Both the FTC–DOJ provision and the Treasury provision provide analogous responsibilities to the U.S. counterpoint, but the specific party may be different.

**Parties and the Transaction**  
Item 2(a) requests the filer to provide ultimate parent entities of all acquiring persons and the ultimate parent entities of all acquired persons. The IRS can use this information as a starting point to ascertain related-party relationships for Section 482 transfer pricing. Item 2(b) addresses the type of transaction contemplated or undertaken, but the form permits the preparer to select more than one box.

Item 2(c) specifies the notification threshold, the size of the transaction, as being $50 million, $100 million, or $500 million. Item 2(d) addresses value of the voting securities, the percentage being acquired, the value of the assets to be held as a result of the acquisition, and the total value of the assets. Item 2(e) addresses the identification of the party making the fair market valuation.

**Specific Items Affecting the Transaction**  
Item 3(a) requires the preparer to describe the acquisition. The instructions specify that the preparer must include the name and mailing address of each acquiring and acquired person, whether or not required to file the Notification. Item 3(b) speaks to the assets to be acquired and the assets held by the acquiring person. Item 3(c) addresses the specifics of a voting stock acquisition, including the dollar value of securities in each class. Item 3(d) requires the preparer to include a copy of the acquisition contract or agreement, or an intent to merge or acquire.

**Specific Items Relied Upon and Filed**  
Item 4 requires just three types of items: documents filed with the SEC, annual financial reports, and “studies, surveys, analyses, and reports.” This third group within item 4 should be specifically of interest to the international examiner seeking to review transfer pricing transactions and by the transfer pricing economist. The instructions to item 4(c) speak of the following categories of economic documentation, all of which will be relevant to Section 482 transfer pricing:

- Market shares
- Competition
The information concerning competition should be relevant to an international examiner seeking to set up an adjustment based on the comparable profits method. All too often, some international examiners seek the course of least resistance and reach too quickly to the SIC manual, relying on the taxpayer’s representation of its primary SIC code. The list of competitors in 4(c) is likely to be far more relevant.

The acquirer will most frequently prepare such economic documentation to justify and support the acquisition. The acquiror prepares the Notification and Report Form with a view toward obtaining a preclearance “all clear” from the FTC and DOJ. In this regard, the acquirer is likely to emphasize the heavy competition on the part of the business’s competitors, the strength of these competitors, and the limited market share even after the acquisition takes place.

Such a study is likely to reflect market intangibles, the impact of intellectual property such as patents, trademarks, and the like. The studies may reflect intended economies of scale and an “efficiency” argument. All of this information will be of great interest to the international examiner and to the transfer pricing economist.

**Detailed Information Reflecting the North American Industry Classification System (NAICS)—United States, 1997**

At the present time, taxpayers and the IRS rely on the CPM to compute the most easily determined transfer pricing method, though not necessarily the best method. The CPM relies heavily on the SIC system, but the NAICS system is to ultimately replace the SIC system.

Item 5(a) requests dollar revenues by industry. This information is to be reflected by use of the six-digit NAICS industry code. Item 5(b)(i) requests dollar revenues by manufactured products. This information is to be reflected by the use of the 10-digit NAICS code.

Both the industry data and the manufacturing products data refer to 1997 total dollar revenues. We believe that the Form may be in error in calling for 1997 data. The year 1997 indicates the NAICS promulgation, but this information may not necessarily be relevant to antitrust issues that the Form is designed to address.

Item 5(b)(ii) seeks information about products added or deleted, described by the 10-digit NAICS product code. A business may be selling part of its operations or cease certain activities in its quest for antitrust clearance. Additions typically reflect scalar economies or other efficiencies than an increase in transfer pricing transactions.

Item 5(b)(iii) seeks dollar revenues by manufactured product class. Item 5(c) seeks dollar revenues by nonmanufacturing industry. The manufactured product classes are determined at the seven-digit NAICS level. The dollar revenues for the nonmanufacturing industry can be determined by the six-digit NAICS code. The instructions for the Form indicate that industries for which the dollar revenues totaled less than $1 million in the most recent year may be omitted. Item 5(d) addresses the acquisition in the context of a joint venture, including contributions, contracts, credit guarantees, consideration, business description, and dollar revenues.
Shareholders, Holdings, and Entities Item 2(a) had addressed information concerning the ultimate parent entities of all acquiring persons and the ultimate parent entities of all acquired persons. In contrast, item 6(a) seeks information concerning entities within the person filing the Notification, most typically the subsidiaries of the person filing the notification. The instructions to item 6(a) specify that the person seeking the Notification may omit entities with total assets of less than $10 million. Item 6(b) seeks shareholders of the parent seeking the Notification. The instructions to item 6(b) specify that shareholders include the ultimate parent and that holders need not be listed for entities with total assets of less than $10 million. Item 6(c) seeks information as to the holdings of the person filing the Notification.

Dollar Revenues and Geographic Market Information Item 7(a) seeks dollar revenues, specified by the six-digit NAICS code and description. Item 7(b) requests the name of each person who derived dollar revenues. Item 7(c) requests geographic market information. Of the three items, geographic market information is most significantly related to the transfer pricing inquiry. As a general matter, the geographic information required by item 7(c) is significantly more detailed than required for transfer pricing purposes, but this information can be used to challenge or substantiate assertions made for transfer pricing purposes.

Previous Acquisitions Item 8 seeks information concerning previous information from the acquiring persons. For each such acquisition, the acquiring persons are to supply the following:

- The name of the entity acquired
- The headquarters of the entity prior to acquisition
- Whether the acquiring person acquired securities or assets
- The consummation date of the acquisition
- The six-digit NAICS code in which the acquired entity derived dollar revenues

Item 8 has two safe harbors, a $1 million exclusion and a $10 million exclusion. The person filing the Notification is to reflect each six-digit NAICS code for which the filer derived dollar revenues of $1 million or more in the most recent year. The acquired issuer either derived revenues of $1 million or more in the recent year or derived revenues of $1 million or more in the most recent year attributable to the acquired assets. The $10 million amount applies to joint ventures.

The material in italics explains the background for the request is for IRS use only. The international examiner may opt to exclude this material in issuing the standard transfer pricing information document request.

PROPOSED SECOND STANDARD TRANSFER PRICING INFORMATION DOCUMENT REQUEST

Classification

This information document request seeks information regarding revenues, expenses, U.S.-connected products and services, and net income for lines of commerce, deter-

**Consistency**

All information sought pursuant to this information document request shall be prepared in conjunction with the information otherwise requested and submitted pursuant to the Notification and Report Form for Certain Mergers and Acquisitions, 16 C.F.R. Part 803—Appendix.

**Applicability**

The information document request seeks detailed information regarding each acquisition of assets or voting stock that is $50 million or more, based on the aggregate total of assets and voting stock to be held as a result of the acquisition. Information pertaining to acquisitions of less than $50 million, based on the aggregate total of assets and voting stock to be held as a result of the acquisition, are exempt.

**Information Requested**

Information requested is to be determined under two NAICS levels:

1. Unless otherwise specified, the information sought must be reflected at the six-digit NAICS national industry code level.
2. Activities pertaining to manufacturing operations (as defined by NAICS Sections 31 through 33) must be submitted at the seven-digit NAICS product class and at the ten-digit NAICS product code level.

**U.S.-Connected Products or Services**

U.S.-connected products or services means products or services that are imported to or exported from the United States by transfers by the taxpayer and any of its related parties. For this purpose, exports are added to each other and are not subtracted. The definition of *U.S.-connected products or services* is taken from the definition of that term as specified in Treasury Regulation Section 1.6038A-3(c)(7)(i). The Second Transfer Pricing Information Document Request terminology is somewhat broader than the comparable term in the regulations. The Second Transfer Pricing Information Document Request refers to all related parties, but Treasury Regulation Section 1.6038A-3(c)(7)(i) applies only to “foreign” related parties.

**Gross Revenues**

Gross revenues means gross receipts in the nature of earning gross income. Gross revenues are taken into account before taking returns or allowances, and are taken into account before determining the cost of goods sold or operating expenses. Gross revenues do not include borrowings, lendings, or the receipt of passive dividend income. This definition is taken from the definition of the gross revenues of an industry segment in Treasury Regulation Section 1.6038A-3(c)(7)(ii).
Operating Income

Operating income is gross revenue minus all operating expenses. The following items cannot be added to or subtracted from operating profit:

- Revenue earned at the corporate level and not derived from operations, such as passive income
- General corporate expenses, except as allocated and apportioned under Treasury Regulation Section 1.861 et seq.
- Interest expense
- Domestic and foreign income taxes

This definition of operating profit is taken from Treasury Regulation Section 1.6038A-3(c)(7)(v).

Operating Expenses

Operating expenses include all expenses of the segment, except for the following expenses:

- General corporate expenses, except as allocated and apportioned under Section 1.861 et seq.
- Interest expense
- Domestic and foreign income taxes

This definition of operating expenses is extracted from the term “operating expenses” in Treasury Regulation Section 1.6038A-3(c)(7)(v) but is not further defined in that section.

General Information

A taxpayer is to provide the following information:

1. Indicate your taxpayer identification number.
2. Specify each acquisition initiated during the tax year under review.
3. Specify each acquisition in process during the tax year under review.
4. Specify each acquisition completed during the year under review.
5. Specify each acquisition initiated during the tax year under review that was subject to the Notification and Report Form, 16 C.F.R. Parts 801–803.
6. Specify each acquisition in process during the tax year under review that was subject to the Notification and Report Form, 16 C.F.R. Parts 801–803.
7. Specify each acquisition completed during the tax year under review that was subject to the Notification and Report Form, 16 C.F.R. Parts 801–803.
8. Indicate the intended tax treatment of each 16 C.F.R. Part 801–803 transaction completed during the year of issue.
10. Enclose a copy of each Form 16 C.F.R. Part 803—Appendix filed or required to be filed in the taxable year of issue. Include any supplemental information included in Form 16 C.F.R. Part 803—Appendix. Include all information requested by the FTC or the DOJ.

**NAICS Reporting**

Specify the following information for each sixth digit, seventh digit, or tenth digit NAICS classification under FTC Form C4 item 5 for the year under review.

11. Gross revenues  
12. Operating expenses  
13. Operating income

**U.S.-Connected Products or Services**

Specify the following information for each sixth digit, seventh digit, or tenth digit NAICS classification under FTC Form C4 item 5 for the year under review.

14. Gross revenues  
15. Operating expenses  
16. Operating income

Amounts provided in items 1 through 4 provide the IRS with comparative data that may lead the international examiner to request subsequent Transfer Pricing Information Document Requests.

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