Chapter 15 Intercompany Transfer Pricing

Contents:

This chapter discusses Internal Revenue Code (IRC) §482 and Treasury Regulations (Treas. Reg.) §1.482-0 through Treas. Reg. §1.482-9. The materials provided in this chapter are intended to provide a general overview of the rules related to IRC §482. These materials are intended to provide a starting point for a California examination of issues related to IRC §482, and are not intended as a reference.

For California franchise tax purpose, intercompany transactions between members of a single combined reporting group are eliminated. However, IRC §482 rules apply with respect to transactions to and from subsidiaries which are either wholly or partially excluded from the group.

15.1 Introduction to Intercompany Transfer Pricing

Contents:

a. Introduction

California allows corporate taxpayers to elect to determine their income on a water's-edge basis. (R&TC §25110.) In general, the water's-edge method allows corporations to exclude the income and apportionment factors of foreign affiliates from the calculation of business income. The effect of the water's-edge election is that foreign unitary affiliates are either wholly or partially excluded from the water's-edge combined report.

A significant accounting issue for water's-edge taxpayers is the computation and assignment of income among related entities within and without the water's-edge group. IRC §482 requires that all transactions between related entities be accounted for at arm's length. "Arm's length" refers to the uncontrolled price that would be used in the open marketplace had the entities been unrelated. (Treas. Reg. §1.482-1(b).)

In general, the term "transfer pricing" refers to the setting of prices on all types of transactions between related parties. For example, it applies to fixing the price on the sale of tangible personal property between related entities, the royalty rate under a patent license, the fee for intercompany services, the interest rate on a loan, or any other amount payable on an intercompany transaction.

International tax sheltering adds to the California tax gap occurs when intercompany transactions between members of the water's-edge combined group and excluded foreign affiliates are not accounted for using arm's length pricing standards. Prices for the goods, services, or intangibles traded between a domestic corporation and a foreign affiliate may not reflect the actual market prices for the same goods, services, or intangibles. For example, goods sold by a domestic parent to its foreign affiliates may be below the price sold in the U.S., or the parent may inflate the price of goods imported from its foreign affiliate to shift profits offshore.

IRC §482 vests authority upon the Internal Revenue Service to distribute, apportion, or allocate income, deductions, credits or allowances between related parties, if necessary to prevent evasion of taxes or to clearly reflect income. Application of IRC §482 to multinational operations may involve a wide range of technical and factual issues. In general, IRC §482 asks whether prices charged by one affiliate to another in an intercompany transaction involving the transfer of goods, services, or intangibles yield results for the transaction that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. California conforms to IRC §482. (R&TC §24725.)

Our goal is to ensure that each water's-edge taxpayer reflects its true taxable income from intercompany transactions as determined under the arm's length standard.

Areas covered by IRC §482 and the Treasury Regulations include:

- Loans
- Use of tangible property
- Sale of tangible property
- Transfer and use of intangible property
- Services
- Cost sharing arrangement

b. History

1. Federal

Transfer pricing issues have long been a source of concern for the Treasury. Since 1917, the US tax system vests the authority upon the IRS to allocate income and deductions among affiliated corporations. The predecessor to current IRC §482 was Section 45 of the 1928 Internal Revenue Act, which authorized the IRS to make adjustments to accounts of related parties to the extent necessary to prevent tax avoidance and to ensure the clear reflection of income.

The current framework relating to arm's length pricing standards dates back to the early 1990s, when the US broke new ground with detailed regulations on intangibles, tangibles, and cost sharing. The final regulations under IRC §482 are applicable for taxable years beginning on or after October 6, 1994. (Treas. Reg. §1.482-1(j)(1).)

Prior to 1986, IRC of 1954 §482 stated:

> *In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent*

> *evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses.*

Effective for taxable years beginning after December 31, 1986, the Tax Reform Act of 1986 (PL 99-514) added what is known as the "super-royalty" provision and introduced the "commensurate with income" standard.

The following sentence was added to the IRC §482 language:

> *In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.*

Congress added the above sentence because of its concern that high-profit intangibles were being transferred outside the U.S. tax jurisdiction without adequate consideration. Congress reasoned that intangibles should be valued based on income they generate over time. (H.R. Rep. 426, 99th Cong., 1st Sess. 424-25 (1985).)

The legislative history of this provision reflects dissatisfaction with the comparability analysis in some judicial decisions:

> *Certain judicial interpretations of section 482 have suggested that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a 'safe harbor' for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. See, e.g., United States Steel Corporation v. Commissioner, 617 F.2d 942 (2d Cir. 1980). While Congress was concerned that such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believe[s] that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfer of intangibles was necessary.*

(Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 1014-15 (1987).)

In 1990, Congress, in IRC §6662, subsections (a), (e), and (h)(2)(A), enacted the 20 percent and 40 percent accuracy related penalties (ARP) for substantial and gross valuations misstatements resulting from transfer pricing adjustments. In 1993, Congress amended these provisions to specifically focus on whether the taxpayer generates contemporaneous documentation and analysis of its transfer pricing decisions. Taxpayers must produce such records within 30 days of any request by the IRS, or risk the imposition of an ARP penalty.

A prevailing perception was that both foreign and domestic corporations abusively shift income from the United States to lower taxing jurisdictions and that large amounts of income escape United States taxation. In response to this perception, Congress directed the Treasury to conduct a comprehensive study of the transfer pricing rules. The study results were presented on October 18, 1988, in what is known as the "White Paper." The White Paper, actually entitled *A Study of Intercompany Pricing*, focused on intangible asset transfers but also covered other aspects of IRC §482. After the White Paper, published in Revenue Notice 88-123, the IRS issued:

- Proposed regulations in 1992,
- Temporary regulations in 1993, and
- Final regulations under section 482 in 1994 through 1996

The 1968 regulations set forth a hierarchy of methods to be used to determine transfer prices. Where the taxpayer or the IRS argued for application of a lower priority method, the hierarchy created a threshold burden to disprove the applicability of the higher priority method or methods not selected.

On July 1, 1994, the proposed regulations were finalized and are effective for taxable years beginning after October 6, 1994. The finalized regulations more fully addressed intangible assets, and it revised the rules related to tangible assets. The final regulations require a different analysis depending on the type of intercompany transaction being reviewed. The basic theory applied throughout the regulations is based on the arm's length standard. However, the priority of methods was removed from the regulations. The IRS must apply the "best method" in the taxpayer's case.

The IRS' improvements in the administration of IRC §482 include:

- Issued final IRC §482 transfer pricing regulations in 1994.
- Issued final regulations under IRC §6662 imposing an accuracy related penalty to transfer pricing adjustments. (Treas. Reg. §1.6662-6.) The statutory penalties under IRC §6662(a), (e), and (h) were enacted for missing the arm's length standard. IRC §6662(e) applies the 20 percent "accuracy related penalty" with respect to certain large transfer pricing adjustments. IRC §6662(h) doubles the penalty to 40 percent if the price adjustment is attributable to one or more gross

valuation misstatements, as provided under IRC §6662(h)(2). (Treas. Reg. §1.6662-6(a)(1).)

For purposes of the IRC §482, an exception applies if the taxpayer has documentation establishing that it used the best method under the Treasury Regulations. The regulations require that such method provides the most reliable measure of an arm's length price. (Treas. Reg. §1.6662-6(d)(2)(ii).)

- Encouraged taxpayers to use the Advance Pricing Agreement (APA) program to provide certainty and advanced resolution of potential transfer pricing disputes. The APA is a voluntary process, but it may protect the taxpayer from both against a section 482 adjustments and IRC §6662(e) penalties. (Rev. Procs. 2006-9 and 99-32.)

Overall, the IRS focus is to shift from after-the-fact audit and litigation to encouragement of upfront taxpayer compliance and advance resolution of transfer pricing issues. (IRS Publication 3218 (4-1999).)

The Treasury Regulations provide for the following affirmative adjustments:

- The IRS can compel each of the commonly-controlled taxpayers to report the taxable income that would have resulted from dealing at arm's length with other members of the group, even if this is contrary to legally enforceable arrangements that were established for business reasons and without any tax avoidance motive. (Treas. Reg. 1.482-1(a)(1).)

- The taxpayer cannot compel the IRS to make or initiate an IRC §482 allocation. Although a taxpayer can reflect an allocation that satisfies IRC §482 on an original return (to the extent allowed by Treas. Reg. §1.482-1(a)(3)), a taxpayer cannot amend a tax return to apply a different intercompany pricing method and file a claim for refund. Only the IRS has the authority to invoke IRC §482, while the taxpayer can then raise offsetting IRC §482 adjustments. For example, if the IRS raises an IRC §482 issue with respect to the performance of services, the taxpayer can raise an offsetting IRC §482 adjustment with respect to interest.

Refer to Instructions for Examiners on Transfer Pricing Issue Examination Scope - Appropriate Application of IRC §6662(e) Penalties.

2. California

i. Revenue and Taxation Code (R&TC)

R&TC §24725 conforms to IRC §482 and has been present in the R&TC since 1951. Prior to the enactment of water's-edge provisions, R&TC §24725 was used infrequently. Under worldwide combined reporting, the risk of improper intercompany transfers is minimized because intercompany transactions are generally eliminated.

The FTB has not adopted any regulations under R&TC §24725. Absent state regulatory authority, we follow federal regulations, case law, IRS legal documents (e.g., Legal Ruling, Notices, Revenue Procedures) pursuant to IRC §482. (*Fujitsu IT Holdings, Inc. v. Franchise Tax Board* (2004) 120 Cal.App.4th 459.)

R&TC §25114 encompasses specific IRC §482 language and was enacted with the water's-edge provisions effective for taxable years beginning on or after January 1, 1988. It requires that FTB examine every return for potential IRC §482 noncompliance. (R&TC §25114(a).) It also states that the FTB must generally follow the federal rules, regulations, and procedures pursuant to IRC §482 for taxable years beginning on or after January 1, 1988. (R&TC §25114(b)(2).)

ii. California Code of Regulation (CCR) §25114

R&TC §25114 requires that FTB examine all returns filed on a water's-edge basis. It also provides that FTB follow the federal rules, regulations, and procedures of IRC §482. FTB adopted regulations under R&TC §25114 which provide:

1. We follow the IRS principles and procedures in conducting examinations under IRC §482 to prevent the evasion of taxes or to clearly reflect the income of two or more organizations, trades, or businesses. (CCR §25114(a)(2).)

2. There are presumptions regarding examinations conducted by the IRS under IRC §482:

   a) If the IRS makes a final adjustment, it is presumed to be correct and no further FTB adjustment is required on the issue or transaction adjusted. (CCR §25114(b)(1)(A).) The FTB or the taxpayer may overcome this presumption by showing that:

i) The adjustment or failure to make the adjustment was erroneous,
ii) Minimum tax effect was the result of making correlative or offsetting adjustments, including NOLs, foreign tax credits, or the shifting of income or deductions between years, or
iii) Substantially the same result was obtained under other sections of the IRC. (CCR §25114(b)(2).)

b) If the IRS makes or proposes no adjustment, no adjustment is necessary. (CCR §25114(b)(1)(B).)

3. There is no presumption of correctness if the IRS did not conduct an examination under IRC §482. (CCR §25114(b)(3).)

4. Definitions:

a) The term "examine" means to review or inspect a tax return, which may or may not include an audit of the return. (CCR §24114(d)(1).)
b) The term "examination" is an audit of the tax return, including a desk audit as well as a field audit. (CCR §25114(d)(2).)

The burden of proof to demonstrate that an adjustment is clearly erroneous would fall on whoever wishes to disprove the adjustment. Also, no inference can be drawn from the IRS' failure to pursue the issue, nor can a presumption be made that the transactions were correctly reported.

When scoping a water's-edge tax return, consider whether there are potential intercompany transfer pricing issues. Review the regulations under IRC §482, IRS' Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When reviewing these federal sources, account for differences in federal and state law and terminology.

c. IRC §482 in General

Corporations that are owned or controlled by the same interests have the ability to structure an intercompany transaction in such a way as to reduce the total tax liability of the affiliated group of corporations through the artificial shifting of income or deductions. Intercompany transfer pricing is the practice of determining the price to be paid or charged for property or services transferred from one affiliated corporation to another.

IRC §482 grants broad authority to the government to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers in order to prevent evasion of taxes or to clearly reflect income. The Treasury relies on IRC §482 to correct artificial intragroup pricing policies that are employed by taxpayers to achieve two primary goals:

- In the domestic area, to shift income from the top income bracket of one corporation to the bottom (or zero) brackets of related corporations; and
- In the foreign area, to shift income from a domestic corporation, taxable on its worldwide income, to affiliated foreign corporations that are not generally subject to United States tax on their foreign sourced income.

This chapter is intended to apply to all types of transactions between related parties involving both inbound and outbound transactions. The term "inbound" refers to the flow of goods or services into the United States. The term "outbound" refers to the flow of goods or services out of the United States.

The purpose of IRC §482 is to prevent the artificial shifting of the net incomes of controlled taxpayers by placing controlled taxpayers on a parity with uncontrolled, unrelated taxpayers. (*Seagate Technology, Inc. & Consolidated Subs*. (1994) 102 T.C. 149; *Bausch & Lomb, Inc. v. Commissioner* (1989) 92 T.C. 525, affd. 933 F.2d 1084 (2d Cir. 1991).) IRC §482's focus is on economic reality, rather than the taxpayer's motivation or purpose. In other words, the rules of IRC §482 are applied to determine the true taxable income from the business activities of a controlled taxpayer by comparing its controlled transactions to the same type of transaction between unaffiliated corporations.

Example

Acme Corporation, a California manufacturer of aircraft components, sells products to Acme Italia, its Italian subsidiary, and to unrelated customers in Italy. Acme sells the product for $13,000 to Acme Italia and the same product to unrelated customers for $16,000. As a result of Acme undercharging Acme Italia, taxable income of $3,000 is shifted from the United States to Italy.

Example

Agri Corporation sells a tracker to a related foreign subsidiary with resulting taxable income of $5,000, reportable in the United States. The auditor determines the same type of tracker is sold to an unrelated foreign corporation. However, the unrelated sale creates taxable profit of $15,000. The unrelated sale is considered to be transacted at an arm's length price because the transaction occurs between unrelated parties. Applying IRC §482, Agri's United States taxable income would be increased by $10,000.

Potential for transfer pricing issues arise from a wide variety of dealings between related corporations. IRC §482 can be applied to any intercompany transaction. (Treas. Reg. §§1.482-1(f)(1) and 1.482-1(i)(7).) Such intercompany transactions could include:

- Borrowing and lending money
- Renting or leasing of property
- Furnishing management or other services
- Transferring of income producing assets
- Sharing facilities, properties and services

In an international context, income may be shifted from entities with relatively high effective rates of tax to those with relatively low effective rates. Deductions or losses may be shifted from entities with relatively low effective rates to those with relatively high rates. Further, income may increase the earnings and profits of one corporation to cause the characterization of distributions to shareholders as taxable dividends rather than a tax-free return of capital.

By conforming to IRC §482, the FTB has considerable discretion in making adjustments in cases where two or more entities are subject to common control, and where such control has influenced transactions between the entities. The courts have recognized this breadth of authority with respect to the IRS' application of IRC §482. In general, the courts have sustained the IRS' IRC §482 adjustments unless the taxpayer has demonstrated that the IRS has been "...unreasonable, arbitrary or capricious." (*Richard D. Foster v. Commissioner* (1983) 80 TC 34, 140-142, aff'd, 756 F2d 1430 (9th Circuit 1985), cert. denied, 106 S. Ct. 793 (1986); *Home Improvement Company, Inc. v. O'Donnell, Jr*., 67-2 USTC 9702; *Grenada Industries, Inc. v. Commissioner* (1951) 17 TC 231, aff'd 202 F2d 873 (5th Circuit 1953), cert. denied, 346 US 819 (1953).)

This broad discretion is balanced by the fact that, in general, the courts have not permitted the IRS to disregard corporate entities established for a legitimate purpose. Common control of two or more entities may provide an opportunity for income shifting, but it is not enough to show that such opportunity exists. The courts have required that the IRS demonstrate that such circumstance has been exploited through dealings between the controlled entities which were not on an arm's length basis. (*Bush Hog Manufacturing Company, Inc., v. Commissioner* (1964) 52 TC 601.)

Detailed regulations under IRC §482 govern the application of the arm's length standard. The regulations address the full range of transactions occurring between related organizations: the borrowing and lending of money; the performance of management, technical, research or other services; the common use, lending, or rental of tangible property; and the transfer of tangible and intangible property, including stock in trade. Note the term "stock in trade" refers to the sale of inventory.

Example

Acme Corporation lends $1,000,000 to Acme Italia at four percent simple interest. If Acme Italia were to borrow this amount from an unrelated party, the market rate would have been 17 percent compounded interest. Income is being shifted from the United States to Italy. IRC §482 may be applied in this case.

Example

Acme Corporation borrows $1,000,000 from German Acme at 20 percent compounded interest. If Acme Corporation were to borrow this amount from an unrelated party, it would have paid 15 percent compounded interest. Income is being shifted from the United States to Germany. IRC §482 may be applied in this case.

d. Key Terms

1. Key components of the final regulations

i. Arm's Length Standard

   It refers to the uncontrolled price that would be used in the open marketplace had the entities been unrelated. (Treas. Reg. §1.482-1(b)(1).)

ii. Arm's Length Range

   The final regulations recognize that the application of a pricing method may produce:

   - A single result that is the most reliable measure of an arm's length result, or

- Multiple results from which a range of reliable results may be derived.

There is no adjustment if the results reported by the taxpayer for a controlled transaction fall within the arm's length range of reliable results. (Treas. Reg. §1.482-1(e).) The regulations provide rules for defining the range, including rules for increasing the reliability of the analysis where inexact comparables are used.

iii. Best Method Rule

Under the regulations, the arm's length result of a controlled transaction must be determined under the method that, under facts and circumstances, provides the most reliable measure of an arm's length result. There is no strict priority of methods. (Treas. Reg. §1.482-1(c).)

In the selection of the best method, the two primary factors to take into account are:

- The degree of comparability between the controlled and uncontrolled transactions, and
- The quality of the data and assumptions used in the analysis.

If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method.

iv. Comparability

Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. Accordingly, specific factors for determining comparability should be considered in applying and selecting different methods. The regulations elaborate upon the factors for determining comparability. In general, factors affecting comparability are:

- Functions
- Contractual terms
- Risks
- Economic conditions
- Property or Services

The regulations flexibly recognize that comparability need not be exact, but the uncontrolled transaction either must be, or must be adjusted to be, sufficiently similar to provide a reliable measure of an arm's length result. Generally, adjustments based on commercial practices, economic principles, or statistical analyses must be made for material differences between the controlled and uncontrolled transactions, if the reliability of the measure is improved. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis is reduced. The extent and reliability of any adjustments affects the relative reliability of the analysis under the best method rule. (Treas. Reg. §1.482-1(d).)

2. Prerequisites to IRC §482 Adjustments

There are key terms used in the statutory language of IRC §482 that must be present for an IRC §482 adjustment to be pursued. These terms are discussed further below.

i. Two or More Organizations, Trades, or Businesses

IRC §482 may be applied "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated)." (IRC §482.) The regulations emphasize the broadest interpretation possible of the terms organization, trade, or business. The terms are broad enough to cover any type of taxable entity or enterprise which has independent significance for tax purposes. (IRC §1.482-1(i)(2).)

The term "organization" includes any organization of any kind. (Treas. Reg. §1.482-1(i)(1).) This includes sole proprietorships, partnerships, trusts, estates, associations or corporations, as each is commonly understood and defined by the IRC and the regulations thereunder. This is irrespective of:

- Place of organization, operation, conduct, trade, or business
- Whether the organization is domestic or foreign
- Whether or not the organization is exempt
- Whether or not it is a member of an affiliated group that files a consolidated federal return

The term "trade or business" includes any trade or business activity of any kind, regardless of where organized, whether owned individually or otherwise, and regardless of the place where carried on. Rev. Rul. 88-3 (1988-1 C.B. 268) provides guidance on what constitutes a "US trade or business." In general, the term is almost always employed to describe the process of producing or seeking to produce income from actively engaging in business activities, as distinguished from merely owning income-producing property.

In the past, corporations argued that a holding company, engaged in the holding of stocks of various subsidiary corporations, could not be considered a trade or business under §45 of the Revenue Act of 1928. The courts rejected this argument on the basis that the holding company's business was conducted through its subsidiaries and that Congress could not have "intended to leave holding companies free to avoid taxes and subject only their subsidiaries to the terms of the statute." (*Asiatic Petroleum Company v. Commissioner*, 79 F2d 234 (2nd Circuit 1935), cert. Denied, 296 US 645 (1935).)

ii. Common Ownership or Control

IRC §482 can only be invoked when entities are "...owned or controlled directly or indirectly by the same interests..." (Treas. Reg. §1.482-1(a)(3).) Treas. Reg. §§1.482-1(i)(3)-(6) and (8) provide an expansive definition of common control. The term "owned or controlled" implies that control can exist without some requisite form of ownership, either direct or indirect. The Courts describe control under IRC §482 as one of "actual, practical control rather than any particular percentage of stock ownership." (*W.L. Gore Inc. v. Commissioner*, T.C. Memo. 1995-96.) The regulations under IRC §482 state, "Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose." (Treas. Reg. §1.482-1(i)(4).) Thus, any kind of control, however exercisable, is sufficient for purposes of IRC §482.

For the purpose of determining control, the term "indirectly" suggests that application of the attribution rules does apply, although IRC §482 does not contain formal attribution rules or stock ownership requirements, e.g., by referencing to IRC §318 or IRC §957. The absence of a bright-line test has led to a great deal of controversy. Regardless, the courts have applied attribution rules in determining whether or not control exists. (*Charles Town, Inc., v. Commissioner* (1966) 25 TCM 77, aff'd 372 F2d 415 (4th Circuit 1967), cert. denied, 389 US 841 (1967); *Grenada Industries, Inc., v. Commissioner* (1951) 17 TC 231, aff'd 202 F2d 873 (5th Circuit 1953), cert. denied, 346 US 819 (1953).)

As mentioned above, do not just look at ownership to determine whether control exists. The statute recognizes that control can exist even when the control is not evidenced by actual ownership. To prevent form from taking precedence over substance, look beyond the mere ownership percentages of the group.

iii. Distribute, Apportion, or Allocate

IRC §482 states that "...the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances..." Literal interpretation of this phrase would require the IRS to allocate every item of gross income and each applicable gross deduction. Obviously, this would be overly burdensome for the IRS. Accordingly, the authority to allocate gross income has been construed to encompass an allocation of net income. (*Hospital Corp. of America v. Commissioner* (1983) 81 TC 520.)

There is no requirement that income be realized before IRC §482 can be invoked. The IRS can require related corporations to recognize income on intercompany transactions even though the transaction has not yet generated any income from outside of the controlled group. (*Likens-Foster Honolulu Corporation v. Commissioner*, 840 F2d 642 (9th Circuit 1988); *Latham Park Manor, Inc., v. Commissioner*, 69 TC 199 (1977), aff'd 618 F2d 100 (4th Circuit 1980).) Thus, for example, a cash basis taxpayer would be required to recognize arm's length income allocated to it under IRC §482 even if it had not received an actual payment from the related party. As noted by the Tax Court in *Central de Gas de Chihuahua, S.A. v. Commissioner* (1994) 102 T.C. 515, "There can be no doubt that the authority of respondent to allocate income encompasses the conclusion that such allocation 'creates' a deemed payment. Any other view would render such an allocation nugatory in a host of situations implicating the application of section 482..."

The regulations finalized in 1994 clarified that realization of income is not a prerequisite for an IRC §482 allocation to be made, even if the income ultimately anticipated from a series of transactions has not been or is never realized. Further, even if controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation pursuant to IRC §482 is not precluded. (Treas. Reg. §1.482-1(f)(1)(ii).)

While the examples in the regulations are primarily concerned with the effects of actual transactions between or among the controlled group (e.g., intercompany loans, services, etc.), the language in the regulations does not appear to be so restrictive.

One issue that may raise questions is the interplay of IRC §482 with nonrecognition provisions.

Another issue is whether an adjustment could be made under the authority of IRC §482 to situations where one entity had absorbed expenses of another? There are two cases with similar facts that deal with this bifurcation of income and expense issue, *Central Cuba Sugar Company v. Commissioner* (198 F2d 214 (2nd Circuit 1952), cert. denied, 344 US 874 (1952)), and *Rooney v. United States* (305 F2d 681 (9th Circuit 1962)). In both cases, the taxpayers were required to match income with expenses.

In the first case, the taxpayer grew a sugar cane crop and incurred all the costs of planting and growing the crop. Prior to the harvest, the taxpayer transferred assets, including the sugar cane crop, to a Cuban corporation pursuant to a plan of reorganization, a non-taxed transaction. The result was a bifurcation of the income and the expenses. The IRS did not contest the reorganization; rather its argument centered on the timing of the transfer, which took place after the expenses had been incurred but before the sale of the crop. The court sustained the allocation of income back to the parent corporation. The second case had a very similar set of facts. Again, the allocation of income back to the corporation incurring the expenses was upheld by the court.

iv. Evasion of Taxes

One purpose of IRC §482 is stated in the statutory language itself as "...to prevent evasion of taxes..." The phrase "evasion of taxes" connotes the intent to defraud. The issue that taxpayers raised was whether or not the IRS had to demonstrate intent to evade tax before IRC §482 could be invoked. The courts interpreted this phrase to mean that the mere avoidance of tax, regardless of the taxpayer's motivation or intent, was sufficient to invoke IRC §482. (*Asiatic Petroleum Company v. Commissioner*, 99 F2d 234 (2nd Circuit 1935), aff'd 31 BTA 1152, cert. denied, 296 US 645 (1935).)

The regulations finalized in 1994 also clarified this point. The authority to determine true taxable income extends to any case, whether by inadvertence or by design, if the taxable income is not at arm's length. The intent to evade or avoid tax is not a prerequisite to making an IRC §482 allocation. (Treas. Reg. §1.482-1(f)(1).) Further, the IRS is not restricted to cases where improper accounting occurs; fraudulent, colorable or sham transactions have occurred; or where a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits or allocations has occurred. (Treas. Reg. §1.482-1(f)(1) and (f)(1)(i).)

This is true even if income is shifted to a taxing jurisdiction having a higher tax rate. (Treas. Reg. §1.482-1(a)(1).) Thus, for purposes of IRC §482, the auditor does not need to demonstrate intent by the taxpayer to defraud the government.

v. Clear Reflection of Income

An additional purpose as stated in the statutory language of IRC §482 is to "...clearly reflect income." Income is considered to be clearly reflected when the "true taxable income" of the controlled group is recognized.

True taxable income means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting by reason of the particular contract, transaction or arrangement the controlled taxpayer chose to make even though such contract, transaction or arrangement is legally binding upon the parties. (Treas. Reg. §1.482-1(i)(9).)

A strict reading of this phrase may lead one to believe that the emphasis is on intercompany transactions. But what about the assignment of income or expenses to a sham corporation? Historically these issues were handled by invoking IRC §61, IRC §162 or IRC §446. The landmark case addressing this was *Lucas v. Earl* (1930) 281 US 111. In *Lucas*, the US Supreme Court stated that income is taxable to the one who earns it, regardless of whether that person made a legally binding contract to have it paid to another. Income may not be split merely by assigning income. The assignment should be disregarded for tax purposes unless the taxpayer also assigned the income-producing property.

There is evidence that the courts have expanded this concept of the clear reflection of income to include assignment of income or expense shifting doctrines. For example in *Rubin v. Commissioner* (1968) 51 TC 251, rev'd and rem'd, 429 F2d 650 (2nd Circuit 1970), on remand 56 TC 1155 (1971), aff'd 460 F2d 1216 (2nd Circuit 1972)), the Tax Court originally attributed management fees to the taxpayer based on IRC §61. On appeal, the Second Circuit reversed the tax court decision and remanded the case for reconsideration under IRC §482. The higher court clearly preferred the flexibility of IRC §482 to the "all or nothing approach" of IRC §61. On remand, the Tax Court applied IRC §482 to allocate the income.

Thus, to ensure that the clear reflection of income occurs, the IRS can disregard legally binding agreements between related parties and analyze the true taxable income of a transaction. Further, the clear reflection of income concept can be applied to other intercompany transactions.

e. IRC §482 Interaction with Nonrecognition Provisions

If necessary, to prevent the avoidance of tax or to clearly reflect income, the IRS may apply IRC §482 to transactions even though the taxpayer would otherwise qualify for the nonrecognition of gain or loss by applying provisions such as IRC §351 or §1031. (Treas. Reg. §1.482-1(1)(f)(iii).)

f. Collateral Adjustments

When the IRS makes an allocation pursuant to IRC §482, the regulations require that the IRS take into account appropriate collateral adjustments. (Treas. Reg. §1.482-1(g)(1).) Appropriate collateral adjustments include three adjustment classifications:

- Correlative adjustments
- Conforming adjustments
- Set-off adjustments

R&TC §25114(b)(2) states that the FTB must follow the federal rules and regulations pursuant to IRC §482. Thus, the FTB would also be required to take into account appropriate collateral adjustments.

1. Correlative Adjustments

By its nature, IRC §482 is not merely a disallowance section. Whenever an allocation to adjust the income of a member of a controlled group is made, referred to as the primary adjustment, appropriate correlative adjustments to the income of any member involved in the allocation must also be made. For example, assume as the primary adjustment, an allocation is made that involves the engineering services in connection with the construction of an oil rig. The correlative adjustment would be the adjustment needed to reflect an increase to the basis of the oil rig. Or, if the net taxable income of a United States taxpayer is increased, based on sales from a controlled foreign corporation (CFC) for which subpart F income was reported, then a correlative adjustment would be needed to reduce the CFC's subpart F income and the CFC's earnings and profits.

A correlative adjustment is not considered made until the date of a final determination occurs with respect to the allocation under IRC §482. A final determination includes:

- The date of the assessment of the tax following the execution of Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment;
- Acceptance of Form 870-AD, Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment;
- Payment of the deficiency;
- Stipulation in the Tax Court of the United States; or
- Final determination of the tax liability by offer in compromise, closing agreement or court action. (Treas. Reg. §1.482-1(g)(2)(iii).)

The correlative adjustment is to be made concurrently with the primary adjustment if the United States tax liability of the other member is affected for any income year in which a refund of taxes is not barred by the statute. Care should be taken, however, to ensure a refund based on a correlative adjustment is not prematurely issued. No refund should be issued until it is clear that the primary adjustment will be sustained.

There are situations in which the United States income tax liability of the other member is not affected for the income year because the other member:

- Has a net operating loss, and the allocation increases or decreases such loss; or
- Is a foreign corporation, for which there is no United States taxing jurisdiction.

In such cases, the correlative adjustment is deemed to have been made, for the purpose of determining the United States income tax liability of the other members for a subsequent income year, or, for any person for any income year. For cases in which the correlative adjustment is deemed to have been made, the IRS must furnish to the taxpayer, who was the subject of the primary adjustment, a written statement of the amount and nature of all correlative adjustments. (Treas. Reg. §1.482-1(g)(2)(ii).)

2. Conforming Adjustments

Appropriate adjustments must be made to conform the taxpayer's accounts to reflect allocations made under IRC §482. Such adjustments may include the treatment of an allocated amount as a dividend, as a capital contribution, or as a repayment of the allocated amount without further income tax consequences. The conforming adjustments are made by applying the procedures specified in Rev. Proc. 99-32, which superseded Rev. Proc. 65-17.

For example, if an allocation is made that increases the taxable income of a United States corporation because the intercompany price was not originally at arm's length prices, the corporation may request relief through Rev. Proc. 99-32 and establish an account receivable from the foreign corporation to receive the actual cash payment without triggering a duplicate tax liability.

3. Set-Off Adjustments

If an allocation is made pursuant to IRC §482 with respect to a transaction between controlled taxpayers, the IRS must also take into account the effect of any other non-arm's length transaction between the same controlled taxpayers for the same taxable year. This results in a set-off adjustment against the primary IRC §482 allocation. For example, assume the primary adjustment pursuant to IRC §482 relates to the sale of tangible property. The taxpayer may argue that a set-off adjustment exists that relates to services provided to the controlled taxpayer. The IRS would be required to make this set-off adjustments as long as the taxpayer satisfies the requirements.

Also, if the effect of the set-off adjustment is to change the characterization or source of the income or deductions that effects the United States tax liability of any member, then adjustments must be made to reflect the proper classification or source of each category of income or deductions. (Treas. Reg. §1.482-1(g)(4)(i).) For example, income may be re-characterized to increase or decrease earnings and profits. While this may not affect the immediate income year, this will subsequently affect the amount of reportable dividend income.

However, there are requirements that the taxpayer must meet before the IRS can take into account a set-off adjustment. (Treas. Reg. §1.482-1(g)(4)(ii).) The taxpayer must:

- Establish that the transaction that is the basis of the set-off adjustment was not at arm's length and what the amount of the appropriate arm's length charge should be;
- Document all correlative adjustments resulting from the proposed set-off adjustment; and
- Notify the IRS of the basis of any claimed set-off adjustment within 30 days after the earlier of: the date of the letter by which the IRS transmits an examination report notifying the taxpayer of the

proposed adjustments, or the date of the issuance of the notice of deficiency.

4. Statute Of Limitations

When a transfer pricing adjustment is made, a deemed distribution or other conforming adjustments may occur. See Treas. Reg. §1.482-1(g)(3) and Rev. Proc. 99-32 for a discussion of conforming adjustments. Accordingly, the statute of limitations is to remain open for the duration of the IRC §482 examination. This may require the taxpayer to sign waivers extending the statute of limitations:

- Federal – Form 870 - Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment
- California – Form 3570 – Waiver Extending Statute of Limitations for Proposing Deficiency Assessments

The FTB should also notify the taxpayer when an intercompany pricing issue is going to be pursued so that the taxpayer has the opportunity to protect any appropriate statutes.

g. Relief from Double Taxation

1. In General

As the result of the IRS audit, the United States taxable income is generally increased by the IRC §482 allocation. However, this amount has already been reported by the taxpayer in another foreign country. If an adjustment is made to the United States taxable income without decreasing the foreign taxable income, the income would be taxed by both countries. The reverse situation can also occur. For example, a foreign country may increase the foreign taxable income. If an adjustment to decrease the United States taxable income is not made, the income would be taxed by both countries.

When double taxation occurs as a result of an IRC §482 adjustment, the taxpayer has two choices to seek relief. One choice is to request assistance from Competent Authority if the adjusted transaction occurred with a related corporation that operated in a foreign country that has a tax treaty with the United States. The other option available to the taxpayer is to request assistance applying Rev. Proc. 99-32, which allows resulting cash payments, otherwise treated as dividend income, to be offset with the IRC §482 adjustment.

For California purposes, there is no equivalent to the IRS Competent Authority. Accordingly, for California purposes, the application of Rev. Proc. 99-32 is generally the only option for the taxpayer. Alternatively, the taxpayer may attempt to negotiate relief from the foreign government on its own.

2. Competent Authority

Competent Authority is a mechanism established by the tax treaty to resolve issues that may arise that affect the taxpayer, the United States and the foreign country. Thus, Competent Authority exists only for situations where the effected foreign government has a tax treaty with the United States. Competent Authority is located in the IRS National Office and operates on behalf of the United States taxpayer. It negotiates with the foreign government when an IRC §482 allocation causes double taxation.

When a foreign government has made an adjustment under the authority of statutes comparable to the United States IRC §482 provisions causing a tax overpayment in the United States, the taxpayer cannot compel the IRS to apply IRC §482. Relief can only be obtained through Competent Authority. Competent Authority negotiates with the foreign taxing agent to resolve the double taxation.

h. IRC §482 Interaction with Other Provisions

There are additional provisions that involve or have an impact on transfer pricing issues. The IRS has the option of using IRC §61, adjusting the cost of goods sold; IRC §162, disallowing deductions that are not ordinary and necessary; or IRC §482 to properly reflect income. IRC §446(b) also gives the IRS the authority to change a taxpayer's method of accounting when it does not clearly reflect income. The IRS can accomplish the same result by using IRC §482.

When IRC §61, §162, §367, or §446(b) apply, there is no mandatory collateral adjustment to be made and the taxpayer has no relief available under Rev. Proc. 99-32.

i. FTB Audit Responsibility

1. In General

Audits of multinational corporations filing on a water's-edge combined basis that have transactions between entities that are within and without the water's-edge group have the potential for intercompany transfer pricing issues. R&TC §25114(a) requires that the FTB examine every return for potential IRC §482 noncompliance. The FTB follows the federal regulations, rules, and procedures to address this issue. (R&TC §25114(b).)

There are a number of sources to review to better understand IRC §482. The regulations pursuant to IRC §482 contain several examples that are not included in this manual. Read the regulation applicable to your particular type of intercompany. Further, reading recent IRC §482 cases will demonstrate the amount of required information related to the taxpayer's business and its industry that is needed to generate an IRC §482 adjustment (e.g., *Westreco, Inc. v. Commissioner* (1992) 64 TCM 849; *Perkin-Elmer Corporation v. Commissioner* (1993) 66 TCM 634; *Seagate Technology, Inc., v. Commissioner* (1994) 102 TC No.9; *National Semiconductor Corporation v. Commissioner* (1994) 67 TCM 2849; *Compaq Computer Corp. v. Commissioner* (1999) TCM 1999-220; *DHL Corp. v. Commissioner* (1998) TCM 1998-461.

2. Evaluating Whether IRC §482 Noncompliance Exists

The primary objective is to collect enough information to evaluate the intercompany transactions of the taxpayer and to make a reasonable recommendation based on the facts and circumstances of the case.

There are no bright-line tests to determine the extent of potential pricing noncompliance with great accuracy. If the taxpayer's financial ratios consistently vary widely from the industry's average ratios over a period of years, it may be an indication of pricing noncompliance. Another indication of noncompliance may be if the taxpayer consistently reports losses in the U.S. while the worldwide affiliated group is operating at a substantial profit. The provision of substantial services to foreign affiliates for no compensation is yet another indication. The facts and circumstances of each case will determine whether or not the case should be pursued. The analysis of potential noncompliance should be performed as early in the audit cycle as possible to ensure a sufficient statute of limitations remains to address the issue should it be determined that a pricing issue must be pursued.

The conclusion not to pursue a case can be made at the audit level but only after an adequate analysis has been performed for the entire audit cycle. Reasons to not pursue a case include:

- No or minimal intercompany transactions between the foreign and domestic groups;
- Transfer prices appear reasonable based on the analysis conducted by the auditor, encompassing comparisons to industry standards;

- The potential pricing issue is immaterial; or
- The IRS is auditing the pricing issues for the same income years.

Should you determine that there is a potentially material pricing issue, the recommendation whether to pursue an IRC §482 audit should be forwarded to the Multistate Program Office Manager for review and approval. If the Multistate Program Office Manager agrees that a potentially material pricing issue exists, the recommendation will then be forwarded to the Director, Multistate Audit Program Bureau. If approval for the audit is granted, prepare a detailed audit plan. Generally, a team of experienced personnel, including, as needed, program specialists, attorneys, and an economist will assist with the audit. To the extent applicable, follow the IRS's Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

Keep in mind that the FTB is precluded by statute from examining pricing issues that are being or have been examined by the IRS. If the IRS is examining the taxpayer on pricing issues, this fact must be documented in the program item of the audit file. For example, include copies of the IRS International Examiner's Information Document Requests (IDRs).

The IDRs will typically identify the entities being reviewed and the taxable years involved. If it is not clear that you have IE coverage for the California issues, the IE can be contacted to discuss the issue once the appropriate disclosure procedures have been followed.

There is no standard approach or solution to any IRC §482 issue. Each case is decided on its own peculiar set of facts. Pursuant to IRC §482, you are not dealing with the law per se, which is clear, but with factual situations. To make a reasonable determination, you must obtain all the relevant facts and understand the circumstances related to the taxpayer and its industry.

k. Summary

The purpose of IRC §482 is to prevent the artificial shifting of income and deductions between related parties. Though IRC §482 itself contains only 130 words, there are numerous pages of regulations and an extensive history of court cases.

This section introduced IRC §482 and the concept of the arm's length standard. This section also addressed the history and general purpose of

IRC §482, the definition of several key terms, the interaction with other code sections, collateral adjustments and the FTB's audit responsibility. When dealing with transfer pricing issues, to the extent applicable, follow the examination techniques discussed in the IRS's Internal Revenue Manual (IRM), and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

15.2 Loans and Advances

Contents:

a. Introduction

Treas. Reg. §1.482-2(a) specifically applies to the borrowing and lending of money between members of a controlled group. The rules related to loans and advances were not changed by the 1994 finalized regulations. The rules remain within Treas. Reg. §1.482-2(a) and continue to apply.

This section primarily focuses on intercompany loans and advances between the water's-edge group and its foreign affiliates. When analyzing intercompany accounts, consider the intercompany loans and advances made to excluded affiliates to determine whether or not the issue should be pursued.

b. In General

1. Interest on Indebtedness

The authority allowed by Treas. Reg. §1.482-2(a) extends only to determine the appropriateness of the rate of interest charged on the principal amount of bona fide indebtedness between members of a controlled group. (Treas. Reg. §1.482-2(a)(1)(ii).) This includes:

- Loans or advances of money or other consideration (whether or not there is a written instrument); and
- Trade receivables arising from sales, leases or the rendition of services by or between members of a controlled group, or any other similar extension of credit.

If there is no bona fide indebtedness, the provisions of Treas. Reg. §1.482-2(a) do not apply. (Treas. Reg. §1.482-2(a)(1)(ii)(B).)

Treas. Reg. §1.482-2(a) provides the authority and method to reflect an arm's length rate of interest for loans and advances between related parties. (Treas. Reg. §1.482-2(a)(1).) A loan or advance is classified as either a term loan or as a demand loan. A term loan, or advance, includes indebtedness which is to be paid either in installments or otherwise at some fixed date or dates in the future. IRC §7872(f)(5) defines a demand loan as any loan payable in full at any time on demand by the lender or any loan with an indefinite maturity. Most intercompany trade receivables would be classified as demand loans.

The general rule states that when a member of a controlled group makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not at an arm's length rate of interest, then IRC §482 will apply and appropriate allocations to reflect an arm's length rate of interest for the use of that loan or advance may be made. Treas. Reg. §1.482-2(a) applies to both in-bound and out-bound indebtedness.

Example

USCO loans $10 million to its Peruvian subsidiary, Lima, at a 4 percent, simple interest rate loan. The market interest rate for a similar loan type would have been 12 percent, compounded monthly. An IRC §482 allocation would be necessary to increase USCO's interest income applying the appropriate market terms to USCO's loan.

Treas. Reg. §1.482-2(a), requiring an allocation for interest on loans and advances, has been challenged in court. The primary argument against this regulation was that imputing interest on transactions which did not give rise to gross income went beyond the scope and purpose of IRC §482. (*Fitzgerald Motor Company v. Commissioner*, 60 T.C. 957, rev'd 75-1 USTC 9522.) However, several courts have upheld the application of Treas. Reg. §1.482-2(a). Thus, this argument has been resolved, (*Liberty Loan Corporation v. United States*, 498 F2d 225 (8th Circuit 1974), rev'd and rem'd 395 F.Supp. 158 (ED Mo. 1973), cert. denied, 419 US 1089 (1974); *Paduano v. Commissioner* (1975) 34 TCM 368), except for the following situation:

In *Pitchford's, Inc., v. Commissioner* (1975) 34 TCM 384, the court accepted the taxpayer's argument against an interest allocation on loans to a related corporation. The argument was based on the theory that at the time the loans were made, the corporation's financial position was so unstable that the accrual of interest would have prevented continuation of the business and the repayment of the loan. Accordingly, the loan amounts were actually a contribution of capital and not bona fide debt.

The Internal Revenue Service conceded that an allocation of interest under IRC §482 was improper in such circumstances, but argued the taxpayer failed to prove the factual basis of the argument. The court expressed no specific view on the question as to whether IRC §482 precludes an allocation when there would not have been a reasonable expectancy of collecting the interest. The court merely accepted the IRS concession to resolve the case.

Therefore, for these regulations to apply, the indebtedness must be real, irrespective of how the transaction is characterized by the parties. Thus, characterization as a bona fide debt is a facts and circumstances test, dependent on whether there was a genuine intention to create a debt, with a reasonable expectation of repayment. An advance which is actually a contribution to capital or payments of interest which are for an alleged sale of property, which in fact constitutes a lease of the property, do not fall within the scope of Treas. Reg. §1.482-2(a). (Treas. Reg. §1.482-2)(1)(ii)(B).)

In general, to avoid the imputation of interest pursuant to IRC §482, an intercompany loan or advance must bear interest one day after the indebtedness arises and continuing until the date the debt is satisfied. However, Treas. Reg. §1.482-2(a) does allow interest-free periods for certain loans and advances. These interest-free periods only apply to indebtedness, which is not evidenced by a written instrument requiring the payment of interest, that arise from intercompany sales, leases or services incurred in the ordinary course of business. Thus, these interest-free periods only apply to intercompany trade receivables. These interest-free periods are discussed in WEM 15.2(e).

2. Loan Guarantees

The guarantee of a subsidiary's debt by a parent corporation is a routine procedure for most multinational corporations. Yet, there is no regulation under IRC §482 that specifically addresses taxpayer loan guarantees of related party borrowing. The IRS has determined that such a guarantee is subject to IRC §482, but a guarantee is analyzed as a service pursuant to IRC §482, rather than a fee for the use of money. (Private Letter Ruling 7822005.)

c. Arm's Length Interest Rate

1. In General

Generally, when the taxpayer can demonstrate that the interest rate applied to a loan or advance is a rate at arm's length, then no adjustment pursuant to IRC §482 is required. The regulations define two interest rates, the arm's length interest rate and a safe haven interest rate.

If the lender is in the business of making loans to unrelated third parties, the true arm's length interest rate must be applied while the safe haven interest rate cannot be applied. The arm's length interest rate must also be applied to any loan or advance when the principal or interest is expressed in a currency other than the United States dollar. (Treas. Reg. §1.482-2(a)(2)(iii)(D) and (E).) Thus, the safe heaven interest rate cannot be applied to loans or advances that are transacted in a foreign currency.

It may be difficult to determine the arm's length interest rate for a foreign currency loan. It may be necessary to look to other IRC sections for guidance on an appropriate rate. For example, for purposes of IRC §7872, the applicable interest rate for loans denominated in foreign currencies is a rate which constitutes a market interest rate in the currency in which the loan is denominated. (Treas. Reg. §1.7872-11(f).)

2. Arm's Length Interest Rate

The arm's length interest rate is that rate of interest that would have been charged at the time the indebtedness arose, in independent transactions between unrelated parties under similar circumstances. All relevant factors must be taken into account in establishing the true arm's length interest rate. These factors include the amount and duration of the loan, the security involved, the credit worthiness of the borrower and the interest rates prevailing at the situs of the lender or borrower for comparable loans. (Treas. Reg. §1.482-2(2)(i).)

When a loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the true arm's length interest rate is the rate actually paid by the lender increased by any costs or deductions incurred by the lender to borrow such amounts and make the loan, unless, it is established that a different interest rate is more appropriate. (Treas. Reg. §1.482-2(2)(ii).)

Example

A United States parent corporation borrows money in Greece at a 7 percent interest rate and re-loans the money to its Greek subsidiary at a 4 percent interest rate. Because the situs of the borrower was in Greece and the market interest rate was 7 percent, the true arm's length rate to apply would be 7 percent plus the borrowing costs of the parent. (Rev. Rul. 74-566.)

d. Safe Haven Interest Rates

1. In General

The regulations provide safe haven provisions that encompass a range of interest rates that are deemed to be arm's length. For purposes of Treas. Reg. §1.482-2(a), an interest rate is deemed to be at arm's length if it falls between specified safe harbor boundaries, ordinarily not less than 100 percent of the Applicable Federal Rate (AFR) and not more than 130 percent of the AFR. If the interest rate charged on the intercompany loan or advance is within the safe haven interest rate range, then an allocation pursuant to IRC §482 would not be necessary.

The safe haven interest rate is not required to be applied if the taxpayer can demonstrate a different interest rate is the true arm's length interest rate and should be applied. Depending on the terms of the loan or advance, the safe haven interest rate will either be the short-term AFR, the mid-term AFR, or the long-term AFR. (Treas. Reg. §1.482-2(a)(2)(iii)(C).) When determining which AFR to apply, the loan period is considered including any options to renew or to extend the loan period.

The floor, or lower limit, is 100 percent of the AFR, compounded semiannually. The ceiling, or upper limit, is 130 percent of the AFR, compounded semiannually. Generally, if the taxpayer's interest rate is between the lower and upper limits, no allocation pursuant to IRC §482 is required. If the interest charge is less than the lower limit, the safe haven interest rate to apply pursuant to IRC §482 will be the lower limit. If the interest rate is higher than the upper limit, the safe haven interest rate to apply pursuant to IRC §482 will be the upper limit.

For loans and advances with no stated interest rate made after May 9, 1986, the lower limit of the AFR range is used for the term of the loan.

2. Exceptions

If the taxpayer is able to establish a more appropriate rate of interest, the true arm's length rate, then that is the interest rate to be used. If the creditor member is regularly engaged in the business of making loans or advances to unrelated parties, the safe haven interest rates cannot be applied to intercompany loans or advances. Instead, the arm's length interest rate must be applied to the loan or advance. (Treas. Reg. §1.482-2(a)(2)(iii)(D).) Also, the safe haven interest rates cannot be applied to any loan or advance where the principal or interest is expressed in a currency other than the United States dollar. (Treas. Reg. §1.482-2(a)(2)(iii)(E).)

Thus, loans payable in foreign currency do not qualify for the safe harbor interest rates. (Rev. Rul. 74-566.)

For transactions which are categorized as a sale-leaseback transaction, described in IRC §1274(e), the lower limit safe haven interest rate will be 110 percent of the AFR, compounded semiannually. (Treas. Reg. §1.482-2(a)(2)(iii)(B)(3).) Also, for debts arising from any sale or exchange between related parties, the lower limit AFR to be applied will be the lowest three month AFR ending with the first calendar month in which there is a binding written contract in effect for the sale or exchange. Note this lowest three-month rule does not apply to intercompany trade receivables. (Treas. Reg. §1.482-2(a)(2)(iii)(C)(3).)

3. Applicable Federal Rate

A. In General

The AFR is determined by the Department of the Treasury as authorized by IRC §1274(d). Each calendar month the AFRs are determined based upon the average market yields on outstanding marketable obligations of the United States. AFRs are published each month in the Internal Revenue Bulletin (IRB). Each IRB contains the AFRs stated for equivalent annual, semiannual, quarterly and monthly compounding periods. The published rates apply for transactions occurring during that month.

There are three AFR classifications and the appropriate AFR is driven by the loan period of the debt. The classifications are as follows:

LOAN PERIOD	AFR CLASSIFICATION
Three Years or Less	Short Term AFR
Over Three Years, but not over nine years	Mid Term AFR
Over Nine Years	Long Term AFR

Example

Assume that the stated interest rate on a loan, transacted in March 2013, is .25 percent, compounded annually. The original repayment term was two years, three months; therefore the short-term AFR is used. Based on the March 2013 loan date, assume the AFR for that month is obtained and the following analysis is performed:

AFR	Period for Compounding Annual
130%	.22%
	.29%

Note that .29% is determined by multiplying .22% by 130% or by using the AFR chart, example shown below.

Solution: Because the stated interest rate of.25 percent is between .22 percent (100% of the AFR) and .29 percent (130% of the AFR), no adjustment is warranted.

REV. RUL. 2013-7 TABLE 1
Applicable Federal Rates (AFR) for March 2013
Period for Compounding

	Annual	***Semiannual***	***Quarterly***	***Monthly***
Short-term				
AFR	.22%	.22%	.22%	.22%
110% AFR	.24%	.24%	.24%	.24%
120% AFR	.26%	.26%	.26%	.26%
130% AFR	.29%	.29%	.29%	.29%
Mid-term				
AFR	1.09%	1.09%	1.09%	1.09%
110% AFR	1.20%	1.20%	1.20%	1.20%
120% AFR	1.31%	1.31%	1.31%	1.31%
130% AFR	1.43%	1.42%	1.42%	1.42%
150% AFR	1.65%	1.64%	1.64%	1.63%

REV. RUL. 2013-7 TABLE 1
Applicable Federal Rates (AFR) for March 2013
Period for Compounding

	Annual	***Semiannual***	***Quarterly***	***Monthly***
175% AFR	1.92%	1.91%	1.91%	1.90%
Long-term				
AFR	2.66%	2.64%	2.63%	2.63%
110% AFR	2.92%	2.90%	2.89%	2.88%
120% AFR	3.20%	3.17%	3.16%	3.15%
130% AFR	3.46%	3.43%	3.42%	3.41%

Although the short-term AFR will change monthly, this does not necessarily mean that a different interest rate must be used each month to compound interest. For example, the related creditor member may continue to charge the rate originally provided, so long as that rate remains within the 100-130 percent safe haven interest rate range for each succeeding month.

B. Demand Loans

IRC §7872(f)(5) defines a demand loan as any loan payable in full at any time on demand by the lender and, to the extent provided in regulations, any loan with an indefinite maturity. A demand loan is treated as a series of renewed one day loans. Again, most intercompany trade receivables are demand loans.

The AFR that applies to demand loans will equal the short-term AFR in effect for each day on which any amount of such loan or advance, including unpaid accrued interest, is outstanding. (Treas. Reg. §1.482-2(a)(2)(iii)(C)(3).) For this computation refer to Treas. Reg. §1.1274(d). In all likelihood, the demand loan being audited will come under the scope of IRC §7872. IRC §7872 has detailed computational rules for demand loans, including formulas for demand loans not outstanding for an entire compounding period, such as a calendar year. IRC §7872 is discussed in WEM 15.2(f).

4. Summary

In summary, the short-term, mid-term or long-term AFR applies to bona fide loans or advances. If the intercompany transaction is a sales-leaseback, 110 percent of the short-term AFR applies to the transaction. Any bona fide debt arising from a sale or exchange must apply the lowest three-month AFR rule, while intercompany trade receivables will fall under the short-term AFR classification.

e. Interest-Free Periods

1. In General

The period for which interest must be charged with respect to a bona fide indebtedness between controlled entities begins one day after the day the indebtedness arises and ends on the date the indebtedness is satisfied either by payment, off-set, cancellation or otherwise. (Treas. Reg. §1.482-2(a)(1)(iii)(A).)

With respect to intercompany trade receivables, the regulations provide for certain interest-free periods on which interest is not required to be charged. The intercompany trade receivables which qualify for the interest-free periods are those which arise from transactions in the *ordinary course of business* from sales, leases or services between related parties and which are not evidenced by a written debt instrument requiring the payment of interest. (Treas. Reg. §1.482-2(a)(1)(iii)(A).)

If more than one intercompany trade receivable exists between members of a group, payments are first applied against the earliest amount outstanding. Thus, the group is required to use a first-in, first-out (FIFO) order to determine whether the intercompany trade receivables were paid within the interest-free period. (Treas. Reg. §1.482-2(a)(1)(iii)(E)(4)(iv).)

For intercompany trade receivables arising after June 30, 1988, Treas. Reg. §1.482-2(a)(1)(iii) provides different interest-free periods depending on the type of intercompany trade receivable involved. There are four types of intercompany trade receivables contemplated by the regulations, including those arising from:

- Certain intercompany transactions in the *ordinary* course of business (the debtor member's business is conducted within the United States). (Treas. Reg. §1.482-2(a)(1)(iii)(B).)
- Transactions carried on in a trade or business conducted outside the United States by the debtor member. (Treas. Reg. §1.482-2(a)(1)(iii)(C).)
- A trade or business where the creditor member's industry, as a regular practice, allows unrelated parties a longer payment period without charging interest. (Treas. Reg. §1.482-2(a)(1)(iii)(D).)
- Property purchased for resale in a foreign country. (Treas. Reg. §1.482-2(a)(1)(iii)(E).)

For purposes of these classifications, the term "the United States" includes any possession of the United States, and the term "foreign country" excludes any possession of the United States. (Treas. Reg. §1.482-2(a)(1)(iii)(A).) Therefore, any trade receivables arising from a trade or business conducted in a United States possession (e.g., Puerto Rico) would be classified as a type one trade receivable.

Under the general rule for intercompany trade receivables, all amounts arising in a particular month are treated as a "block" of receivables. To determine the average collection period for which an amount owed by one member of the group to another member is outstanding, payments made or other credits to the trade receivables are considered to be applied against the earliest amount outstanding. Thus, payments or other credits are applied against amounts in a FIFO order. Since payments are applied on a FIFO basis, tracing payments to individual intercompany trade receivables is generally not required, in order to determine whether a particular trade receivable was paid within the applicable interest-free period. (Treas. Reg. §1.482-2(a)(1)(iii)(E)(4)(iv)(A).)

Notwithstanding the FIFO rule, the creditor may apply payments or credits against amounts owed in another order, in accordance with an agreement or understanding between the related parties if it is demonstrated that the creditor or others in the creditor's industry, as a regular trade practice, enter into similar agreements or understandings with respect to balances with unrelated parties. (Treas. Reg. §1.482-2(a)(1)(iii)(E)(4)(iv)(B).)

2. Certain United States Intercompany Transactions

With respect to the first type of trade receivable mentioned above, interest need not be accrued on the intercompany receivable until the first day of the third month following the month in which the trade receivable arises. (Treas. Reg. §1.482-2(a)(1)(iii)(B).)

Example

Puerto Rican Sound, a corporation organized in a United States possession, sells 2,300 compact disc players to its United States parent. The intercompany trade receivable arises on June 15. Interest must be charged on this trade receivable from September 1 until the date of full payment.

Example

On October 18, USCO sells 20 engine blocks to a brother-sister affiliate in the United States, for which a trade receivable is established. The United States affiliate pays the full balance due on the following June 3. Interest must be charged on this trade receivable from January 1 through June 3.

Example

X and Y are members of a controlled group. X incurs $100 in intercompany trade payables to Y during May, and an additional $200 in intercompany trade payables to Y during June. On July 15, X pays $60 on its intercompany trade payable. On August 31, X pays the remaining $240. Assuming the general rule applies (three-month), the interest-free period for the May intercompany trade receivables ended on July 31. The interest-free period for the June intercompany trade receivables ended on August 31.

The $60 payment is applied to the earliest intercompany trade receivable. Because Y received the payment before the end of the interest-free period (July 31), no interest is required for $60 of the May intercompany trade receivables. The August 31 $240 payment is applied to the remaining $40 of the May intercompany trade receivables and then to the $200 June intercompany trade receivables (FIFO basis). The $40 was paid after the interest-free period (July 31), so interest is required to be accrued on that amount (e.g., interest expense to X and interest income to Y). The June intercompany trade receivables were paid in full before the end of its interest-free period. Therefore, no interest is required to be accrued on the June receivables.

3. Certain Foreign Intercompany Transactions

With respect to the second type of trade receivable, where the debtor member's trade or business is located outside of the United States, interest is not required to accrue until the first day of the fourth calendar month following the month in which the transaction arises. (Treas. Reg. §1.482-2(a)(1)(iii)(C).)

Example

Malaysian Sound buys 4,100 compact disc players from its United States parent. The intercompany trade receivable arises on June 15. Interest must be charged on this trade receivable from October 1 until the date of full payment.

4. Regular Industry Practice

This interest-free period applies to the regular trade practice of the creditor member or the creditor's industry. If the creditor member or unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated parties an interest-free period that is longer than the payment period allowed by the first and second receivable types discussed above without charging interest, then the longer interest-free period will be allowed with respect to a comparable amount of intercompany trade receivables. (Treas. Reg. §1.482-2(a)(1)(iii)(D).)

Note that this language is specific in that this must be the *regular* trade practice for the creditor member or the creditor's industry to discourage taxpayers from engaging in a small number of transactions with unrelated parties for the sole purpose of establishing a comparable uncontrolled interest-free period.

Example

A Malaysian subsidiary sells 1,200 refrigerators to its United States parent on November 25. The United States parent pays the balance due on its intercompany trade receivable on May 15. The rule provided for this type of trade receivable (the first type above) would require that interest be accrued from February 1 to May 15. However, the industry practice would allow six months or 180 days to satisfy the debt. As a result, no interest would be required for this trade receivable.

5. Property Purchased For Foreign Resale

A. IN GENERAL

If, in the ordinary course of business, one member of the group (related purchaser) purchases property from another member of the group (related seller) for resale to unrelated persons located in a foreign country, then the related purchaser and the related seller may use an interest-free period for the intercompany trade receivables arising during the related seller's income year from the purchase of such property within the same product group. Such interest-free period is based upon:

- The related purchaser's average collection period for sales of property within the same product group sold to unrelated parties in the same foreign country; plus
- Ten calendar days. (Treas. Reg. §1.482-2(a)(1)(iii)(E)(1).)

However, this interest-free period can in no event exceed 183 days. Also, the related purchaser does not have to operate outside of the United States in order for this interest-free period to be applied. (Treas. Reg. §1.482-2(a)(1)(iii)(E)(2).) This interest-free period will not, however, apply to intercompany trade receivables attributable to property which is manufactured, produced or constructed by the related purchaser. The meaning of manufactured, produced or constructed is the same as that applied within Treas. Reg. §1.954-3(a)(4). Thus, if the goods are manufactured, produced or constructed, the applicable interest-free period for the attributable trade receivables would be based on one of the three prior trade receivable classifications under which the trade receivable would have otherwise been classified.

Example

Brazilian Ltd., mines, cuts and polishes gems in Brazil then sells the gems to its related United States subsidiary. For purposes of Treas. Reg. §1.954-3(a)(4), Brazilian would be considered to be manufacturing. Therefore, the interest-free period for any trade receivables that arose from these intercompany sales would not be the average collection period plus 10 days. Instead, the interest-free period for this trade receivable would be either the three-month period allowed to United States debtor intercompany transactions or, if applicable, that interest-free period allowed as regular industry practice.

B. AVERAGE COLLECTION PERIOD

There are four computational steps needed to determine the average collection period. See Treas. Reg. §1.482-2(a)(1)(iii)(E)(3) for complete details about these steps.

C. AVERAGE COLLECTION PERIOD EXAMPLE

Example

The purpose of this example is to demonstrate how the average collection period is calculated. Assume Sea Corporation acquires rafts from a related corporation, We 'R Floating, to resell in New Zealand. Determine the interest-free period for Sea for purchases occurring during 2014.

Sea has the following sales in New Zealand and accounts receivable balances as of the end of the month:

MONTH - 2013	NET RAFT SALES	TRADE RECEIVABLES
January	$1,000	$6,500
February	1,000	6,000
March	1,500	5,500
April	1,000	5,500
May	1,000	5,500

June	1,500	6,000
July	1,000	6,000
August	1,500	5,500
September	1,500	6,000
October	1,400	5,500
November	1,000	6,000
December	1,000	5,120
TOTAL	**14,400**	**69,120**

Analysis:

The interest-free period is being determined for 2014. Accordingly, 2013 is the test period.

- Step 1 – Calculate the total sales by the related purchaser, Sea, within the raft product group to unrelated persons located in New Zealand. This amount is $14,400.

- Step 2 – Calculate Sea's average month-end trade receivables balance with respect to the sales determined in step 1. This is $5,760 ($69,120/12 months).

- Step 3 – Calculate the trade receivables turnover rate by dividing the total sales amount determined in step 1 by the average trade receivables balance determined in step 2. Thus, this turnover rate is 2.5.

Total Sales Average Trade Receivables	<u>$ 14,400</u> $ 5,760	=	2.5 Receivable Turnover Rate

- Step 4 – Divide the trade receivables turnover rate determined in step 3 into 365 days, and round the result to the nearest whole number. This result is 146 days (365 days/2.5 turnover rate).

Solution:

The number of days in the average collection period for Sea is 146 days. Therefore, for the intercompany trade receivables incurred by Sea during We 'R Floating's 2014 income year, attributable to the purchase of rafts for sale to unrelated persons in New Zealand, Sea may use an interest-free period of 156 days (146 days in the average collection period plus 10 days, but not over 183 days) before interest income and expense need be accrued on the intercompany trade receivable.

f. Coordination with Other Code Sections

See Treas. Reg. §1.482-2(a)(3) for the order in which the different code sections are applied (e.g., IRC §467, certain rental agreements; IRC §483, imputed interest on deferred payments attributable to the sale of exchange of property; IRC §1274, OID on certain debt instruments; IRC §7872, certain loans with no interest or below market interest rates).

The substance of the transaction must be determined considering all relevant facts and circumstances and any law or rule (e.g., assignment of income, step transactions, etc.,) applicable to the true transaction may apply. Only the rate of interest with respect to the bona fide debt, if any, is subject to adjustment under IRC §482.

If another code section applies, that code section is considered before IRC §482 is considered. For example, IRC §467 can recharacterize portions of lease payments to interest under certain lease agreements.

Example

Assume Ash and Birch corporations are commonly controlled taxpayers. Ash loans Birch $15,000 at a rate of interest that is less than the AFR. In this instance, IRC §7872 is operative. Applying IRC §7872(b) first, the difference between $15,000 and the present value of all the payments due using a discount rate equal to 100 percent of the AFR is considered an OID. After applying these sections, IRC §482 may then be applied to determine if the rate of interest on the adjusted loan is at arm's length. However, because the interest rate is now within the safe haven interest rate range of 100-130 percent of the AFR, no additional interest rate adjustment is needed pursuant to IRC §482.

In summary, once the true substance of a transaction is determined, the other code sections may take precedence over IRC §482. After adjustments are made, then the adjusted transaction must be reviewed to determine if the result is within arm's length boundaries. This discussion of the other applicable code sections related to interest has been very brief. Should the issue arise, review the applicable codes and regulations.

g. Method of Computing Interest

1. In General

For loans and advances other than intercompany trade receivables, the regulations require the computation of a safe haven rate of interest based upon the AFR compounded semiannually. The regulations define the period for which interest must be accrued and the interest rate to apply. However, the regulations do not provide any methods for computing the interest. Computational rules do exist in regulations for IRC §483 and §7872. It is necessary to be aware of the computational rules provided by the other sections, particularly if you need to determine a semiannual rate where taxpayer loans are stated in rates compounded differently, or if you must determine the interest on a demand loan, which is outstanding for less than a full compounding period.

For intercompany trade receivables, the Courts have sustained the calculations used by the IRS as being appropriate based on the facts and circumstances of each case. These calculations include interest computed on an average daily balance (*Collins Electric Company v. Commissioner* (1977) 69 TC 911); on a month-end outstanding balance (*Kahler Corporation v. Commissioner*, 486 F2d 1 (8th Circuit 1973), 73-2 USTC 9687, rev'd and rem'd 58 TC 496 (1972); and on an average month-end balance (*Fitzgerald Motor Company v. Commissioner*, 508 F2d 1096 (5th Circuit 1975), 75-1 USTC 9275 rev'd 60 TC 957).

2. Computations

Whichever code section applies to your transaction, you will find the computational requirements very similar. For example, the computation to find the "total unstated interest" for purposes of IRC §483 and the amount of "foregone interest" for purposes of IRC §7872 is the same.

Both computations define the unstated or foregone interest as the excess of the amount deferred or loaned over the present value of all the payments required under the loan or contract. What makes the computations different is the particular rate requirements of the code section. For example, for contracts entered into after December 31, 1984, IRC §483 bases the discount factor on the AFR, as do the other code sections.

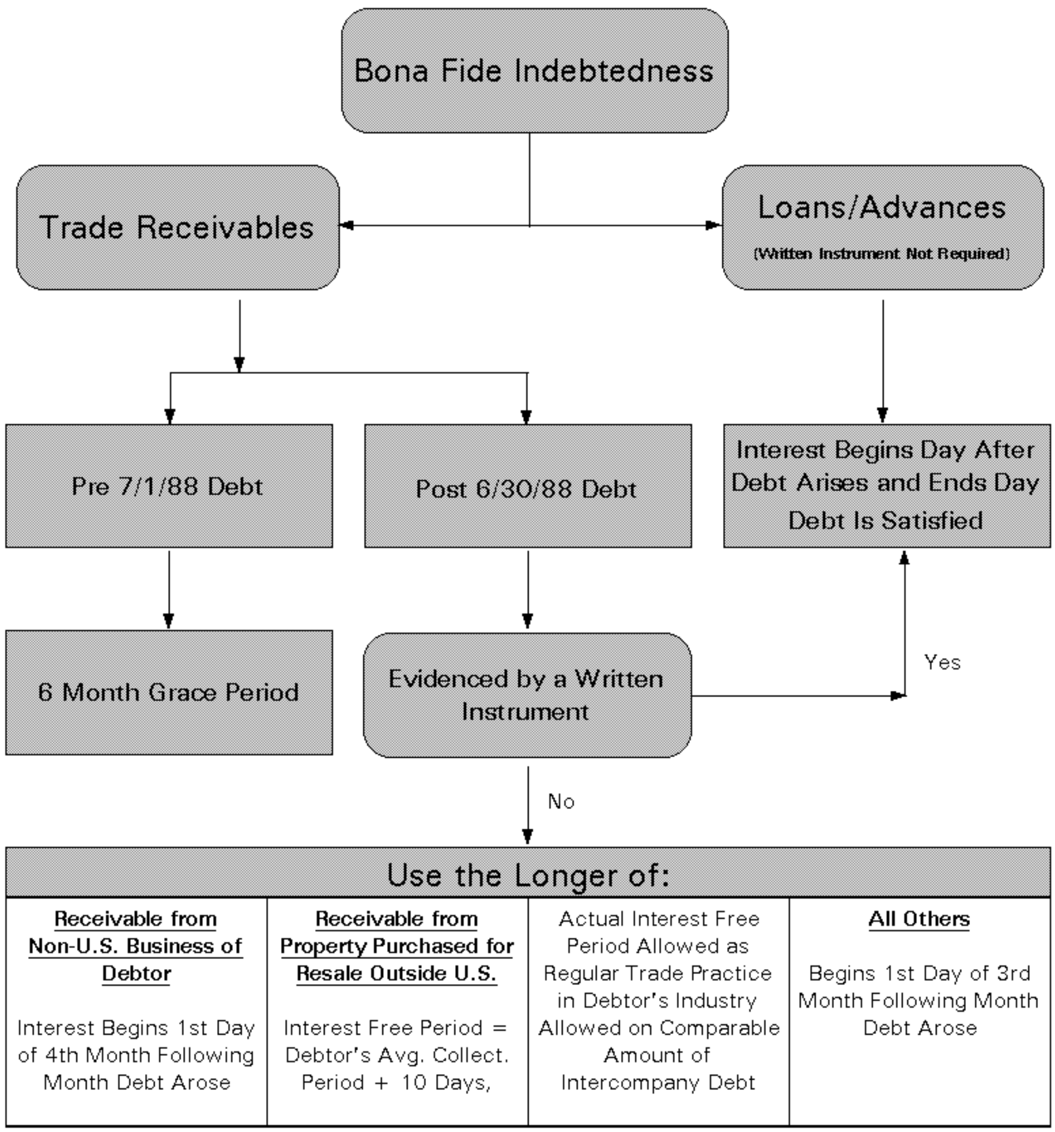
Therefore, to perform any computation, you need to know the amount of the principal, the amount of any stated interest, how many payments to be made and the appropriate discount rate to be used in the present value computation. This is where the code sections differ, because each code section requires different test rates which meets that section's particular goals.

See Treas. Reg. for examples illustrating the above rules.

3. Conclusion

This section includes just a few examples from the regulations. Once you determine which IRC section applies to the loan or advance transaction, read the additional examples in the regulations.

Application of IRC §482



h. Summary

1. Treas. Reg. §1.482-2(a) provides that when one member of a controlled group charges another member of the group no interest or a non-arm's length rate of interest on a loan or advance, an allocation of interest must be made to apply an arm's length interest rate.
2. Treas. Reg. §1.482-2(a) applies to all forms of bona fide loans or advances, including:
   a. Loans or advances of money or other consideration, whether or not evidenced by a written instrument; and

   b. Trade receivables arising from sales, leases or the rendition of services by or between members of the group, or any other similar extension of credit.

3. There are two interest rates provided in Treas. Reg. §1.482-2(a), the arm's length interest rate and the safe haven interest rate. The arm's length interest rate is based on independent comparables, while the safe haven interest rate is based on AFRs. Only the arm's length interest rate can be used when the lender is in the business of making similar loans to either related or unrelated parties or if the loan or advance is transacted in a currency other than the United States dollar. The taxpayer can avoid an allocation pursuant to Treas. Reg. §1.482-2(a) by using the safe haven interest rates. The taxpayer can also overcome an allocation pursuant to Treas. Reg. §1.482-2(a) by demonstrating that the reported interest rate is a true arm's length interest rate.
4. Except for intercompany trade receivables, the period to which interest must be charged begins the day after the loan is made and ends on the day it is satisfied. Intercompany trade receivables are allowed an interest-free period, during which interest is not required to be accrued. This exception only applies to trade receivables that arise in the ordinary course of business. The interest-free period may be determined by applying one of these four alternatives:

   a. Applying the general rule, interest is not required to be charged until the first day of the third month following the month in which the trade receivable arises.

   b. When intercompany trade receivables arise from transactions in the ordinary course of a trade or business conducted outside the United States by the debtor member, interest is not required to be charged until the first day of the fourth month after the trade receivable arises.

c. If the creditor member demonstrates it or other unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated persons a longer interest-free period, then that interest-free period can be used with respect to a comparable amount of transactions. This is the trade practice exception.

d. Intercompany trade receivables arising from the purchase of property for resale in a foreign country are allowed an interest-free period equal to the average collection period on receivables to unrelated persons in the same country for the same product plus ten days, up to a maximum of 183 days.

5. The substance of the transaction must first be evaluated. Any bona fide indebtedness is then subject to an allocation pursuant to either IRC §482 or another code section. The other code section, if applicable, will take precedence over IRC §482. Once adjusted, IRC §482 and the regulations are then applied to ensure the adjusted interest rate is an arm's length interest rate.

To the extent applicable, follow the IRS's Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

15.3 Services

Contents:

a. Introduction

This section addresses the second type of transaction contemplated in Treas. Reg. §1.482-2(b), the rendering of services.

b. In General

The term "services" is broadly defined to include any kind of service, such as marketing, managerial, administrative, technical, or any other type.

The regulations deal with situations where one member of a controlled group performs services for another member and there is either no charge at all, excess charge, or an undercharge. For example, if a United States corporation pays excessive commissions to a controlled foreign corporation (CFC), then effectively, the shifting of income occurs. Thus, IRC §482 may be applied when any under-charge or over-charge occurs.

In addition to the application of IRC §482, there are other viable approaches to deal with the problem of related services. One approach is to disallow deductions claimed by the renderer for the costs of the services pursuant to IRC §162, R&TC §24343, because costs incurred for the benefit of another without compensation are not ordinary and necessary expenses of the renderer's trade or business. The deductions for the costs of the services can also be allocated to the recipient who benefitted from the services. (*Leedy-Glover Realty and Insurance Company v. Commissioner* (1949) 13 TC 95, aff'd per curiam, 184 F2d 833 (5th Circuit 1950).) Where substantial assistance is performed for a CFC within the meaning of IRC §954, the CFC's earnings may meet the definition of subpart F income. If this occurs, the CFC could be partially included as discussed in WEM 2.

Depending on the situation, these approaches can be used not only as alternative issues to the other, but also can be used in tandem with one another.

c. Federal Regulatory Time Periods

IRC §482 regulations provide pricing methods for transactions between controlled parties, including transactions involving services. There are generally two regulatory regimes for federal regulatory purposes:

1. Treas. Reg. §1.482-2(b) – This regulation was issued in 1968 and is applicable for taxable years prior to 1987. It provided that an arm's length price be charged for controlled transactions. (Treas. Reg. (2006) §1.482-2(b)(3).) However, this regulation also provided for some kind of safe haven when the service provided was not considered to be an integral part of the business of either the renderer or the recipient. Generally, allocations would be made based on the relative benefits intended from the services:

    i. Non-Integral Services – The regulation permitted certain "non-integral" services to be priced at an amount equal to the direct and indirect costs incurred by the service provider. In effect, the provider of "non-integral" services recovered its costs, but was not required to earn a markup ("cost safe harbor"). (Treas. Reg. (2006) §1.482-2(b)(2) and (3).)

    ii. Integral Services – The arm's length standard for integral services was a comparable market based price, which would include a profit markup for the renderer of services. The regulation required that marketing, managerial, administrative, technical, or other services performed for the benefit of, or on behalf of a related group member without charge or at a charge not equal to an arm's length charge, were subject to reallocation. (Treas. Reg. (2006) §1.482-2(b)(7).)

2. Treas. Reg. §1.482-9(T) – This temporary regulation applies for taxable years between January 1, 2007 and July 31, 2009. This regulation attempted to preserve some of the benefits of Treas. Reg. §1.482-2(b) cost safe harbor.

   Treas. Reg. §1.482-9 – This final regulation applies for taxable years beginning on or after January 1, 2009.

> The parameters of the cost safe harbor were modified by the establishment of the Service Cost Method (SCM). The temporary and final Treas. Reg. §1.482-9 provide for a new transfer pricing method applicable to certain controlled service transactions, the Services Cost Method (SCM). They removed the safe harbor, but implemented specific transfer pricing methods.
>
> Both the temporary and final regulations allow a taxpayer to elect to apply the provisions of current Treas. Reg. §1.482-9 to any taxable year beginning after September 10, 2003. (Treas. Reg. §1.482-9(n).)

For taxable years that begin prior to January 1, 2007, refer to Treas. Reg. §1.482-2(b). For taxable years that begin on or after January 1, 2007, refer to Treas. Reg. §1.482-9, which provides guidance as to how controlled service transactions should be priced and which transfer pricing methodologies are available.

d. Key Terms

Activity

Activity is a transaction by a controlled group member that includes, but is not necessarily limited to, the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making available to the recipient any property or other resources of the renderer. (Treas. Reg. §1.482-9(l)(2).)

Benefit

Prior law codified at Treas. Reg. §1.482-2(b)(1) referred to "marketing, managerial, administrative, technical, or other services." It did not define "benefit."

Under Treas. Reg. §1.482-9(l)(3)(i), "benefit" is an activity considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so.

An activity is generally considered to confer a benefit if an uncontrolled taxpayer in comparable circumstances would be willing to pay for an uncontrolled party to perform the same or similar activity on a fixed or contingent payment basis, or if the recipient otherwise would have performed the same or similar activity for itself.

Controlled Service Transaction or "CST"

A "controlled services transaction" includes any activity by one member of a group of controlled taxpayers (the renderer) that results in a benefit to one or more other members of the controlled group (the recipient). (Treas. Reg. §1.482-9(l)(1).)

The cost charged for CST must be equal to what would be charged at arm's length, as determined under transfer pricing rules, including the "best method" rule, where the method that is shown to be the most reliable measure of an arm's length result must be used. (Treas. Reg. §1.482-9(a).)

Arm's length

Arm's length refers to the uncontrolled price that would be used in the open marketplace, had the entities been unrelated. (Treas. Reg. §1.482-1(b)(1).)

e. Methods to Determine Taxable Income

Treas. Reg. 1.482-9(a) requires an arm's length amount be charged in controlled service transactions to obtain an acceptable pricing arrangement for services to a related party. The final regulation prescribes a lists of methods, which parallel those governing transfer of tangible and intangible property. Each of the methods must be applied in accordance with the best method rule of Treas. Reg. §1.482-1(c), the comparability analysis of Treas. Reg. §1.482-1(d), and the arm's length range of Treas. Reg. §1.482-1(e). The permissible methods are:

- The service cost method
- The comparable uncontrolled services price method
- The gross services margin method
- The cost of services plus method
- The comparable profits method
- The profit split method
- The unspecified methods

Only the service cost method is discussed below. For each of the potentially acceptable methods for determining the appropriate arm's length price for services, see Treas. Reg. §1.482-9 and the examples thereunder.

The Service Cost Method (SCM)

The SCM evaluates whether the price for covered services, as defined, is arm's length by reference to the total services costs with no markup. It permits those eligible routine services listed under Rev. Proc. 2007-13 (2007-1 C.B. 295), and those that are typically not marked up more than seven percent, to be charged at cost.

If the taxpayer applies the SCM, it will be considered to satisfy the arm's length standard when the price charged is at least equal to the total cost of providing the services. The Commissioner's allocations will be limited to adjusting the amount charged for such services to the properly determined amount of such total services costs. (Treas. Reg. §1.482-9(b)(1).) However, Treas. Reg. §1.482-9(b)(2) limits the circumstances when the SCM may apply. It must meet all of the following requirements:

- It is a covered service, which is a controlled service transaction (CST) or a group of CSTs that meet the definition of specified covered services or low margin covered services. (Treas. Reg. §1.482-9(b)(3).)
- It is not an excluded activity. As provided under Treas. Reg. §1.482-9(b)(4), the following service transactions will never be eligible for treatment under the SCM:
    - Manufacturing
    - Production
    - Extraction, exploration, or processing of natural resources
    - Construction
    - Reselling, distribution, acting as a sales purchasing agent, or acting under a commission or other similar arrangement
    - Research, development, or experimentation
    - Engineering or scientific
    - Financial transactions, including guarantees
    - Insurance or reinsurance
- It is not a service that contributes significantly to fundamental risks of business success or failure. (Treas. Reg. §1.482-9(b)(5).)
- Taxpayer must maintain adequate books and records

Covered Service

There are two categories of covered services that are eligible for the SCM:

- The specified covered services – These type of services are common across industry sectors. Generally, they do not involve a significant arm's length markup on total services costs. The regulation tasks the Commissioner to specify such services by revenue procedure. (Treas. Reg. §1.482-9(b)(3)(i).) Thus, a list of specifically covered services is set forth in Rev. Proc. 2007-13, 2007-1 C.B. 295.

- The low margin covered services – These are controlled service transactions for which the median comparable arm's length markup on total services costs of less than or equal to seven percent.

f. Summary

See Treas. Reg. §1.482-9 for the appropriate standards and examples illustrating the application of the best method rule.

- IRC §482 will apply where one related entity performs services for the benefit of another related party at a fee that is other than an arm's length charge. Services are broadly defined and include any service.
- Allocations can only be made if the services are performed with the intention of benefiting the recipient(s). The allocations must be consistent with the benefits intended, regardless of the fact that the benefits anticipated were never realized.
- When tangible or intangible property is transferred, sold, assigned, loaned, leased or otherwise made available to another member of the controlled group and services are rendered by the transferor to the transferee in connection with such transfer, a separate allocation pursuant to Treas. Reg. §1.482-9 is not made.

To the extent applicable, follow the IRS' Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

15.4 Use of Tangible Property

Contents:

a. Introduction

The rules relating to the intercompany use of tangible property did not change with the 1993 temporary regulations, nor the 1994 finalized regulations. The rules remain within Treas. Reg. §1.482-2(c). The regulation was amended in 1988 to repeal a safe harbor rule. With the exception of this change, however, the rules that have applied since 1968, related to the intercompany use of tangible property, continue to apply.

Treas. Reg. §1.482-2(c) is the shortest section within all of the regulations pursuant to IRC §482. In general, application of Treas. Reg. §1.482-2(c) to the intercompany use of tangible property is an easier IRC §482 issue because the arm's length rental charge is based on local rental costs, which are generally easier to determine. Further, in many cases, the assistance and analysis of an economist is not needed.

b. In General

When one related entity owns or leases tangible property and transfers possession, use or occupancy of such tangible property to another related entity without charge, or at a charge which is other than an arm's length rental charge, an appropriate allocation may be made pursuant to IRC §482 to reflect an arm's length rental charge. An allocation may also be made if only a portion of the tangible property is transferred. In this case, the appropriate IRC §482 allocation would be made with reference to the portion transferred. (Treas. Reg. §1.482-2(c).)

In addition to the application of IRC §482, consider whether a rental deduction is allocable to one or more trade or business and/or one or more items of nonbusiness income. For example, if the rental expense relates to a nonbusiness item, the rental expense constitutes a nonbusiness expense, regardless of the ordinary and necessary business expenses as defined by IRC §162. (CCR §25120(d).)

c. Arm's Length Rental Charge

For purposes of the intercompany use of tangible property, the arm's length rental charge is the amount of rent which was charged, or would have been charged, for the use of the same or similar property, during the time the tangible property was used, in uncontrolled transactions with or between unrelated parties under similar circumstances.

Treas. Reg. §1.482-2(c)(2)(i) provides circumstances to be considered when determining the arm's length rental rate include the:

- Period (of time) and location of the tangible property;
- Owner's investment in the tangible property, or rent paid for the tangible property (in case of a sublease);
- Expenses of maintaining the tangible property or maintaining the lease;
- Type of tangible property involved and its condition; and
- All other relevant facts.

Example

Abbott Corporation is in the business of leasing office space and rents space to an unrelated corporation for the monthly rate of $2,000. Abbott also leases an equivalent amount of space to Spruce, Ltd., its subsidiary. The appropriate rental charge to Spruce pursuant to IRC §482 would be the third-party rental charge of $2,000 a month. Furthermore, if Abbott, in addition to leasing the space to Spruce, provides added services in the form of utilities, of which the arm's length charge is $500 a month, then the arm's length rental charge to Spruce would be $2,500. If Abbott only provided these added services to the unrelated corporation, rather than Spruce, then the proper rental charge to the unrelated party would be $2,500, while for Spruce the proper rental charge would be $2,000.

d. Subleases

The 1988 elimination of the safe haven rental charge was not extended to subleases. Therefore, the safe haven rental charge may still be applied for subleases. The safe haven rental charge for a sublease is equal to all the expenses or deductions (including interest) claimed by the lessee, not the sublease or the user, attributable to the period during which the tangible property is used. (Treas. Reg. §1.482-2(c)(2)(iii)(A).) These expenses include:

- Rent paid or accrued by the sublessor;
- Maintenance and repairs;
- Utilities;
- Management; and
- Other similar expenses.

The safe haven rental charge for subleases does not apply when the sublessor is regularly engaged in the trade or business of renting to unrelated parties, tangible property of the same general type as that tangible property in question. As with any safe haven charge or deemed charge, the taxpayer has the option of establishing a more appropriate arm's length rental charge rather than applying the safe haven rental charge. (Treas. Reg. §1.482-2(c)(2)(iii).)

Example

Acorn Corporation subleases property to Bond Company, a related party. Acorn borrows money and makes substantial capital improvements to the leased property, which are to be amortized over the life of the lease. The amortization expense is $12,375. Acorn's interest expense with respect to the funds specifically used for the capital improvements is $3,050. For a sublease, the safe haven rental charge would include both the $12,375 and $3,050. The interest is included here because the expenses included in the safe haven rental charge for a sublease includes all deductions claimed by the sublessor that are attributable to the leased tangible property.

e. Coordination with Other Code Sections

To determine whether or not an allocation for intercompany rental charges must be made pursuant to IRC §482, the issues must be clearly identified. Be aware that a number of code sections may be applicable to the same transaction, e.g., IRC §162 and other IRC §482 sections. Just as in the areas of interest, services and all other transactions between related parties, you should identify them and develop a strategy which will strengthen your audit conclusions by applying one primary position and any appropriate alternative positions. Consider the provisions of CCR §25120(d) dealing with proration of deductions between one or more trades of business and items of nonbusiness.

As with the regulations governing the performance of intercompany services, the regulations here seem to be more concerned with lease transactions where either no rent is charged, or rent charged is much less than an arm's length amount. However, where the rental rate is excessive, there are a number of ways to treat the excess. Depending on the facts and circumstances, the excess could be treated as a constructive dividend or as a contribution to capital. Or, the excess could be disallowed pursuant to IRC §162, as was done in *OTM Corporation v. United States*, 77-2 USTC 9693 (S.D. Tex. 1977), aff'd per curiam, 572 F2d 1046 (5th Circuit 1978), cert. denied, 439 US 1002 (1978).

It may also be necessary to coordinate IRC §482 and IRC §467, Certain Payments for Use of Property or Services. R&TC §24688, which conforms to IRC §467, is effective for taxable years beginning on or after January 1, 1985. There are no guidelines provided either in IRC §482 or IRC §467 as to which section takes priority over the lease transaction. If any inference can be drawn from the application of Treas. Reg. §1.482-2(a)(3) to interest on intercompany loans or advances, IRC §467 would be applied first to characterize the interest and rental elements of the lease payments. Then, IRC §482 would be applied to determine whether the adjusted rental charge was at arm's length. Regardless of Treas. Reg. §1,482-2(c)'s silence, this application appears to be logical considering the specific direction that IRC §482 be applied last in priority in Treas. Reg. §1.482-2(a).

f. Summary

Treas. Reg. §1.482-2(c) authorizes an allocation pursuant to IRC §482 to reflect an arm's length rental charge for the intercompany use of tangible property.

If either related party is engaged in the trade or business of renting or leasing tangible property, the safe haven rental charge cannot be applied. Instead, the true arm's length rental charge must be applied.

In general, the safe haven rental charge is the sum of: the current year's depreciation expense; three percent of the cost of the tangible property; plus, the direct and indirect expenses connected with the tangible property or the lease, excluding interest expense. This calculation does not include any nondepreciable property or tangible property with no determinable useful life.

After May 9, 1986, the regulations retained the safe haven rental charge for subleasing transactions if neither related party is engaged in the trade or business of leasing similar property to unrelated parties.

For subleases, the safe haven rental charge is equal to all the expenses or deductions claimed by the lessee including:

- Rent paid or accrued by the sublessor
- Maintenance and repairs
- Utilities
- Management
- Interest
- Other similar expenses

When considering an issue under the regulations pertaining to the use of tangible property, consider the impact of any other pertinent code section, such as IRC §467 and R&TC §25120 on the transaction.

To the extent applicable, follow the IRS' Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

15.5 Key Components of The 1994 Final Regulations

Contents:

a. Introduction

The 1994 regulations brought about more flexibility in determining the arm's length price for the transfer of tangible and intangible property. The best method rule is a new concept which replaces the priority of methods that has existed since the adoption of the 1968 regulations. The goal of the best method rule is that the best method to be applied is the one creating the most reliable comparable transaction based on the facts and circumstances of the transactions. The application of comparability and its significance to IRC §482 is also explained in the new regulations. The best method rule and the significance of comparability apply to both the intercompany transfer of tangible and intangible property.

b. In General

The regulations finalized in 1994 affect the determination of the intercompany transfer price for tangible and intangible property. While new concepts have been introduced, new methods to calculate prices have also been introduced. These regulations address for the first time the commensurate with income standard that applies to intangible property and was initiated with the Tax Reform Act of 1986 (TRA86). Here are some general observations about the 1994 regulations:

1. The final regulations emphasize comparability and have removed many restrictions.
2. Inexact comparables may be used under all the transfer pricing methods.
3. The elective and other procedural barriers to the use of the profit split and other unspecified methods have been removed.

4. The emphasis on comparability and the importance of the best method rule is a focal point of the regulations:
   - The best method rule must be applied to select the most reliable measure of arm's length results from the available evidence.
   - The best method rule guides the application of all methods.
   - Whenever the available data creates the possibility that more than one method can be applied to a controlled transaction, the best method rule must be applied to determine which of those methods will be selected.
5. In determining which method is the most reliable measure, comparability and the quality of the data and the underlying assumptions are factors to consider.
6. Comparability factors include functions, contractual terms, risks, economic conditions, and property or services involved in the transactions being compared.
7. Factors considered for purposes of evaluating the underlying data and assumptions used in the best method rule, include:
   - Comparable Uncontrolled Price (CUP) Method
   - Completeness and accuracy of data
   - Reliability of the assumptions made; and
   - Sensitivity of results to deficiencies in the data and assumptions used

The following methods apply for the transfer of tangible property:

- Resale Price Method
- Cost Plus Method
- Comparable Profits Method
- Profit Split Method
- Unspecified Methods

For the transfer of intangible property, the 1994 regulations specify four methods that apply for the transfer of intangible property. These methods are discussed in WEM 15.7, and include the:

- Comparable Uncontrolled Transaction (CUT) Method
- Comparable Profits Method
- Profit Split Method
- Unspecified Methods

c. Best Method Rule

1. In General

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. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. (Treas. Reg. §1.482-1(c)(1).)

Information from transactions between unrelated parties provides the most objective basis for determining whether the results of a similar controlled transaction is at arm's length. Thus, in determining which of two or more available methods, or applications of a single method, provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction, or the taxpayer, and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. (Treas. Reg. §1.482-1(c)(2).)

The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction, or taxpayers, and the uncontrolled comparables, considering certain factors, and after making adjustments for certain differences. As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced.

In addition, if adjustments are made to increase the degree of comparability, the number, the magnitude and the reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis obtained under the CUP method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. An analysis will be relatively less reliable, however, as the uncontrolled transactions become less comparable to the controlled transaction. (Treas. Reg. §1.482-1(c)(2)(i).)

Whether a method provides the most reliable measure of an arm's length result also depends upon the quality of the data and assumptions used in the comparability analysis. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled transactions. Such factors are the:

- Completeness and accuracy of the underlying data
- Reliability of the assumptions made
- Sensitivity of the results to the possible deficiencies in the data and assumptions

2. Completeness and Accuracy of Data

The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. An analysis will be relatively more reliable as the completeness and accuracy of the data increases. (Treas. Reg. §1.482-1(c)(2)(ii)(A).)

3. Reliability of Assumptions

All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable, while others may be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method. (Treas. Reg. §1.482-1(c)(2)(ii)(B).)

4. Result Sensitivity to Possible Deficiencies

Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake similar functions, employ similar resources and bear similar risks is particularly important.

Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income and assets may be particularly important.

Thus, a difference between the controlled and uncontrolled transactions, for which an accurate adjustment cannot be made, may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a CUP method analysis, while differences in product characteristics will ordinarily have a greater effect on a CUP method analysis than it would on a comparable profits method analysis. (Treas. Reg. §1.482-1(c)(2)(ii)(C).)

5. Inconsistent Results

If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second method, or another application of the first method, produces results that are consistent with one of the competing applications may be taken into account. (Treas. Reg. §1.482-1(c)(2)(iii).)

Thus, the best method rule replaces the strict priority of methods contained in the 1968 regulations. The best method rule recognizes that the method that provides the most reliable measure of an arm's length result will vary, depending upon the facts and circumstances of the transaction under review. And, when there is no clear best method, an additional factor to consider is whether the results of a particular method are consistent with the results obtained under other applicable methods.

d. Comparability

1. In General

Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. The comparability of transactions must be evaluated considering all factors that could affect the prices. Each method requires analysis of all the factors that affect comparability under that method. This is known as the standard of comparability. Factors for determining comparability include the:

- Functions performed by the entities and the associated resources employed;
- Relevant contractual terms of the transactions;
- Risks incurred by the various affiliated entities;
- Relevant economic conditions of the various markets; and
- Any items of property provided or services performed.

An uncontrolled transaction must be sufficiently similar to the controlled transaction such that it provides a reliable measure of an arm's length result. It need not be identical. Adjustments must be made for material differences if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. These transactions are known as inexact comparables. Such adjustments must be based on commercial practices, economic principles or statistical analyses. If such adjustments cannot be made, the reliability of the analysis will be reduced. Further, unadjusted industry averages, in and of itself themselves, cannot establish arm's length results. (Treas. Reg. §1.482-1(d).)

2. Functions Performed

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed and associated resources employed by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities performed by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed in conjunction with the type of assets used, e.g., plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not, in and of itself, determine the arm's length result for the controlled transaction under review.

Based on Treas. Reg. §1.482-1(d)(3)(i), functions that may need to be accounted for in determining comparability of two transactions include:

- 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, finance, credit and collection, training and personnel management services

3. Contractual Terms

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include the:

- Form of consideration charged or paid
- Sale or purchase volume
- Scope and terms of warranties provided
- Rights to updates, revisions or modifications
- Duration of relevant license, contract or other agreements, and termination or re-negotiation rights
- Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services
- Extensions of credit and payment terms

For example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if the difference would have a material effect on price. Such a comparability adjustment is required even if no interest would be allocated or imputed pursuant to Treas. Reg. §1.482-2(a) or other applicable provisions of the IRC. (Treas. Reg. §1.482-1(d)(3)(ii)(A).)

The contractual terms that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. If the contractual terms are inconsistent with the economic substance of the transaction, the terms may be disregarded and the terms that are consistent with the economic substance of the transaction will be imputed. (Treas. Reg. §1.482-1(d)(ii)(B)(1).)

In the absence of a written agreement, a contractual agreement can be imputed that is consistent with the economic substance of the transaction. Again, in evaluating economic substance, the greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. (Treas. Reg. §1.482-1(d)(ii)(B)(2).)

4. Risks Borne

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. 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
- General business risks related to the ownership of property, plant and equipment. (Treas. Reg. §1.482-1(d)(3)(iii)(A).)

To identify which party bears which risks, the same principal that applies to contractual terms also applies to risks. The allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers, after the outcome is known or reasonably knowable, lacks economic substance. In general, uncontrolled parties will determine which party assumes which risks before the outcome is known. In considering the substance of a transaction, the following facts are relevant:

- Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly.
- Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses.
- The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence

the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control. (Treas. Reg. §1.482-1(d)(3)(iii)(B).)

5. Economic Conditions

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned, in each of the transactions. Economic conditions to consider include the:

- Similarity of geographic markets
- Relative size of each market, and the extent of the overall economic development in each market
- Level of the market, e.g., manufacturer, distributor, wholesaler, retailer or customer
- Relevant market shares for the products, properties, or services transferred or provided
- Location-specific costs of the factors of production and distribution
- Extent of competition in each market with regard to the property or services under review
- Economic condition of the particular industry, including whether the market is in contraction or expansion
- Alternatives realistically available to the buyer and seller

(Treas. Reg. §1.482-1(d)(3)(iv).)

6. Property or Services

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangible that is embedded in the tangible property or services being transferred such as a trademark affixed to tangible property. The comparability of the embedded intangible will be analyzed applying the rules related to intangible property, discussed in WEM 15.7. Also, the relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied.

e. Miscellaneous Considerations

1. Market Share Strategy

In certain circumstances, entities may adopt strategies to enter new markets or increase a product's share of an existing market. This market share strategy would be reflected by temporarily increased market development expenses or resale prices that are temporarily lower than the prices charged for comparable products in the same market. Whether or not the strategy is reflected in the transfer price depends on which party to the controlled transaction bears the costs of the pricing strategy. In any case, the effect of a market share strategy on a controlled transaction will be taken into account only if it can be shown that an uncontrolled taxpayer would engage in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following:

- The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;
- The market share strategy is pursued only for a period of time that is reasonable, taking into account the industry and the product in question; and
- The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established *before* the strategy was implemented. (Treas. Reg. §1.482-1(d)(4)(i).)

Thus, the taxpayer is required to document its market share strategy, which addresses the related costs to implement the strategy, the expected returns, and any agreement to share the related costs, before the strategy is implemented. If the strategy is not documented, the intercompany price, pursuant to IRC §482, will not be adjusted for a market share strategy.

2. Different Geographical Markets

In general, uncontrolled comparables should be derived from the same geographic market in which the controlled taxpayer operates because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable from a different geographical market may be considered if adjustments are made to account for differences between the two markets.

If the information is not available to make these adjustments, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, realizing such differences may affect the reliability of the method for purposes of the best method rule.

For this purpose, a geographic market is any geographical market area in which the economic conditions for the relevant product or service are substantially the same. A geographical market may also include multiple countries, depending on the economic conditions. (Treas. Reg. §1.482-1(d)(4)(ii)(A).)

3. Location Savings

If an uncontrolled taxpayer operates in a different geographical market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographical markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market. See Treas. Reg. §1.482-1(d)(4)(ii)(D) for an example illustrating this rule.

4. Unreliable Comparables

In general, transactions will not constitute reliable measures of an arm's length result for purposes of IRC §482 if:

- They are not made in the ordinary course of business; or
- One of the principal purposes of the uncontrolled transaction was to establish an arm's length result with respect to the controlled transaction. (Treas. Reg. §1.482-1(d)(4)(iii).)

5. Summary

Thus, the effect of a market share strategy can be considered when determining the intercompany transfer price if the strategy is documented before implementation. Also, a comparable transaction that takes place in a different geographical market can be used as long as the price can be adjusted to reflect any significant differences in the economic conditions of the different market. Whether or not the location savings are considered is dependent on who should obtain the benefits of the location savings. That is, whether the savings can be retained (in the form of higher profits due to lower costs) or if the savings must be passed on to the customers (in the form of lower prices) in order for the entity to compete in the market place. And finally, transactions that do not take place in the ordinary course of business or are transacted solely for the purpose of establishing an uncontrolled price are not considered for purposes of IRC §482.

f. Arm's Length Range

The application of a pricing method may produce a single result that is the most reliable measure of an arm's length price. The same method may also generate several results from which a range of reliable results may be derived. An allocation pursuant to IRC §482 will not be made if the controlled taxpayer's results fall within this arm's length range. (Treas. Reg. §1.482-1(e)(1).)

Ordinarily the arm's length range must be established by results derived from two or more applications of the same pricing method to different uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability.

If the information on the controlled transaction and an uncontrolled comparable is sufficiently complete so that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on the price or profit, and an adjustment is made to eliminate the effect of each such difference, then the uncontrolled comparable can be used. The arm's length range will consist of the results of all of the uncontrolled comparables that meet these conditions. The results from applying the same pricing method to these uncontrolled comparables creates the arm's length range. (Treas. Reg. §1.482-1(e)(2)(ii).)

If no uncontrolled comparables meet the above conditions, the arm's length range is derived from the results of all the uncontrolled comparables that achieve a similar level of comparability and reliability. Because the underlying data may not be complete or may contain unidentifiable or un-quantifiable differences, the reliability of the arm's length range must be increased. This is done by removing the outer limits of the range to remove the results that are more likely to be unreliable. In cases where the reliability must be increased, the range may be adjusted by a valid statistical method such as a statistical method that establishes a range where 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. A reliable measure would be the application of an interquartile range, or a different method may be applied if it provides a more reliable measure.

The interquartile range is the range from the 25th to the 75th percentile of the results from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined in the same manner. (Treas. Reg. §1.482-1(e)(2)(iii)(C).)

If the taxpayer's results are outside the arm's length range, an allocation may be made to bring the taxpayer's results to any point in the range. If the interquartile range method is used by the taxpayer, any allocation made will bring the taxpayer's results to the median point. (Treas. Reg. §1.482-1(e)(3).) In addition, there is no requirement that the government establish an arm's length range before proposing an IRC §482 allocation. An adjustment may be based on a single comparable uncontrolled price if the CUP method is properly applied.

g. Multiple Year Analysis

In general, the results of a controlled transaction will be compared with the results of uncontrolled comparables occurring in the same income year as that being audited. It may, however, be appropriate to consider information relating to uncontrolled comparables or the controlled taxpayer for one or more income years before or after the income year being reviewed. If information related to the uncontrolled comparables from multiple income years is used, data relating to the controlled taxpayer for the same income years should also be used. If, however, such data is not available, reliable information from other income years, adjusted for the standard of comparability, may be used. (Treas. Reg. §1.482-1(f)(2)(iii)(A).)

In the following situations, it is appropriate to calculate the intercompany transfer price based on data from more than one income year:

- When complete and accurate data for the income year under review is not available
- When the business cycles within a taxpayer's industry have some effect not reflected in the income year being examined

- When an individual product life cycle needs further examination beyond the immediate income year being examined

The regulations also state that there are certain areas of application where multiple income year data are particularly relevant: risk, market share strategy, periodic adjustments, comparable profits method, and contingent-payment contractual terms for services. (Treas. Reg. §1.482.1(f)(2)(iii)(B).)

h. Foreign Legal Restrictions

Foreign legal restrictions will be taken into account to the extent that such restriction is shown to affect an uncontrolled taxpayer under comparable circumstances for a comparable period of time. The foreign legal restriction will be considered only if the following conditions are met:

- Restrictions are publicly promulgated and generally applicable;
- Taxpayer exhausts all remedies prescribed by foreign law or practice for obtaining a waiver of such restrictions, other than remedies that would have a negligible prospect of success if pursued;
- Restrictions expressly prevent payment or receipt in any form of the arm's length amount and are not simply restrictions on deductibility of an expense; and
- Related parties did not engage in transactions to circumvent restrictions. (Treas. Reg. §1.482-1(h)(2).)

If the above requirements are met by the taxpayer, any portion of the arm's length amount, the payment or receipt of which is prevented because of applicable foreign legal restrictions, will be treated as deferrable until payment or receipt of the relevant item ceases to be prevented by the foreign restrictions. In addition, the taxpayer must meet the following requirements to use the deferred income method of accounting:

- Establish that payment or receipt of an otherwise arm's length amount was prevented because of an applicable foreign legal restriction described in Treas. Reg. §1.482-1(h)(2)(ii); and
- Elect the deferred income method of accounting. (Treas. Reg. §1.482-1(h)(2)(iii).)

i. Advanced Pricing Agreements

In an effort to resolve controversy surrounding IRC §482 audits, the Internal Revenue Services (IRS) established a procedure to issue advance determinations for pricing methods proposed by the taxpayer. This enables taxpayers to have their controlled pricing structures sanctioned by the IRS for a specified number of years in an Advance Pricing Agreement (APA). The negotiation and approval of an APA can be a lengthy process, so the IRS also offers a streamlined APA process for smaller taxpayers.

A goal of the APA process is to reduce the time and expense of an audit. Under the APA process, the taxpayer must file a specific, detailed pricing proposal with the IRS National Office in Washington D.C.

The information must include detailed descriptions of the effected transactions and the methodology used by the taxpayer in arriving at prices.

In early 2012, the Advance Pricing Agreement (APA) Program merged with that portion of the Office of the U.S. Competent Authority (USCA) that resolves transfer pricing cases under the mutual agreement procedures of the United States' bilateral income tax conventions to form the Advance Pricing and Mutual Agreement (APMA) Program. APMA's mission is to resolve actual or potential transfer pricing disputes in a timely, principled, and cooperative manner.

California does not have a procedure comparable to the federal APA process. However, pricing methods that are approved under a final APA will be presumed to be correct by the FTB unless the APA results are demonstrated to be clearly erroneous. The burden of proof to demonstrate that an adjustment should be made to an APA approved pricing method would fall on whomever wishes to make the adjustment. (R&TC §25114(b)(3).)

An APA may only cover certain transactions during specific tax years. The presumption of correctness from an APA will not extend to a pricing methodology that the taxpayer is seeking to apply beyond the transactions and time period specified in the APA.

j. Summary

1. The long awaited intercompany transfer pricing regulations were finalized in 1994. These regulations provide more flexibility and apply the concept of the best method rule. The best method rule must be applied to select the most reliable measure of arm's length results from the available evidence. The regulations also provide rules related to the commensurate with income standard for the first time since its adoption with the TRA86.
2. The regulations emphasize comparability, the quality of the underlying data, and assumptions.
3. The regulations allow for inexact comparables under all the pricing methods. Comparable transactions no longer have to have the same

circumstances as the controlled transactions as long as adjustments can be made for significant differences.

4. Comparability factors include functions, contractual terms, risks, economic conditions and property or services involved in the transactions compared.
5. The intercompany pricing methods no longer have a hierarchy in usage. The following methods now apply for the transfer of tangible property:

    - Comparable Uncontrolled Price Method
    - Resale Price Method
    - Cost Plus Method
    - Comparable Profits Method
    - Profit Split Method
    - Unspecified Methods

6. The 1994 regulations specify the methods that apply for the transfer of intangible property. These include the:

    - Comparable Uncontrolled Transaction Method
    - Comparable Profits Method
    - Profit Split Method
    - Unspecified Methods

To the extent applicable, follow the IRS' Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

15.6 Transfer of Tangible Property – Determination of An Arm's Length Price

Contents:

a. Introduction

This section deals with the determination of an arm's length price when tangible property is transferred between related parties.

b. Overview of the Regulations

Before each method can be discussed in detail, the overall structure of the regulations pursuant to IRC §482 should be reviewed. Treas. Reg. §1.482-1 provides the general terms to be applied when determining the intercompany transfer price. This regulation describes the best method rule, comparability, and the arm's length range. Treas. Reg. §1.482-3 addresses methods to determine taxable income in connection with a transfer of tangible property and lists the six methods available for determining a price with respect to tangible property. It also discusses in detail four of the six methods. Treas. Reg. §1.482-5 specifically explains the comparable profits method, while Treas. Reg. §1.482-6 explains the profit split method. The comparable profits and profit split methods apply to the transfer of both tangible and intangible property.

Treas. Reg. §1.482-3 contains many examples not included in this section demonstrating these concepts. Should you pursue an intercompany pricing issue related to the transfer of tangible property, review Treas. Reg. §1.482-1, Treas. Reg. §1.482-3, Treas. Reg. §1.482-5 and Treas. Reg. §1.482-6.

The six methods that can be used to determine the arm's length price for the transfer of tangible property include the:

- Comparable Uncontrolled Price (CUP) Method
- Resale Price Method
- Cost Plus Method
- Comparable Profits Method
- Profit Split Method
- Unspecified Methods

Although the particular requirements differ for each method, there are basic similarities among them. For each method, comparable transactions must be found with which to compare the controlled transactions. These comparables may be in the form of independent sales involving one of the entities of the controlled group. However, most comparable transactions involve independent sales transactions between two other entities not related to either the taxpayer or its foreign affiliates. For either situation, the circumstances of the uncontrolled sale must be sufficiently similar to the circumstances of the controlled sale. Also, adjustments must be made for differences between the controlled and the independent transactions which have a reasonable and ascertainable effect on the price or profit of the comparables.

However, adjustments to be made are not the same with respect to all methods. For example, for purposes of the CUP method, an intangible used in connection with the property sold may not be considered to a have a reasonable and ascertainable effect on price, and the presence of such an intangible would render the independent sale transaction not comparable. But for purposes of the resale price method or the cost plus method, the effect of an intangible should be accounted for and an adjustment should be made. Depending on the method used, the adjustment would either be expressed as an adjustment to a price or an adjustment to a gross profit ratio. However, if the effect of any intangible cannot be ascertained, the taxpayer would be precluded from using the resale price method or the cost plus method.

c. Comparable Uncontrolled Price Method

1. In General

The method described as most likely to result in an accurate estimate of an arm's length price is the comparable uncontrolled price (CUP) method. The CUP method makes a comparison of the actual price paid for the property sold in the controlled transaction to the actual price paid for similar property sold in an independent transaction. Examples of comparable transactions include:

- Sales by a member of the controlled group to unrelated parties;
- Sales in which the parties are not members of the controlled group and are also not related to each other; or
- Sales to a member of the controlled group by unrelated parties.

Although it is preferable to seek comparable uncontrolled sales from within the taxpayer's group, it may be possible to determine a comparable uncontrolled sale from completely unrelated transactions. This type of comparison would be more appropriate where fungible property is involved, such as wheat, iron ore, etc., and it is unlikely that there is a substantial effect on price from an intangible such as a trademark or a patent.

3. Post-1994 Regulations

The best method rule considers the degree of comparability (functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed) and the quality of data and assumptions used (completeness and accuracy of the underlying data; reliability of the assumptions made; and sensitivity of the results to the possible deficiencies in the data and assumptions) in the analysis.

Tangible property and circumstances of the controlled and uncontrolled transactions must be substantially similar. (Treas. Reg. §1.482-3(b)(2)(ii).) If reliable adjustments cannot be made for significant product differences, this method can still be used. However, the reliability of the results as a measure of an arm's length price will be reduced.

Treas. Reg. §1.482-3(b)(2)(ii)(3) provides a list of specific examples of the factors that are relevant to the CUP method:

- Quality of product
- Contractual terms (e.g., scope and terms of warranties, sale or purchase volume, credit terms and transport terms)
- Level of the market (e.g., manufacturer, distributor, wholesaler, retailer or customer)
- Geographical market in which the transaction takes place
- Date of transaction
- Intangible property associated with the sale
- Foreign currency risks
- Alternatives realistically available to the buyer and the seller

The CUP method continues to be the preferred method within the regulations. It is based on the use of specific uncontrolled transactions and requires the development of third party pricing data for specific individual products. The CUP method takes the interests of both the buyer and the seller into account because the third party prices reflect the outcome of negotiations between a willing buyer and a willing seller. In theory, the CUP method allocates risk in the same manner as would the market. Also, the CUP method derives a transfer price directly from prices obtained from transactions in which one company sells the same or similar product to an unrelated party. And finally, under the CUP method, the similarity of products generally will have the greatest effect on comparability.

d. Resale Price Method

The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method can be applied when the reseller does not add substantial value to the tangible goods by physically altering the goods for resale. For this purpose, packaging, repackaging, labelling or minor assembly do not ordinarily constitute physical alteration. In addition, this method is not generally used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods. (Treas. Reg. §1.482-3(c)(1).)

If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller of the controlled sale because similar characteristics are more likely to be found. Otherwise, an appropriate gross profit margin can be derived from comparable uncontrolled transactions of unrelated resellers. (Treas. Reg. §1.482-3(c)(2).)

For purposes of determining whether or not the result from applying the resale price method is the most reliable measure of an arm's length result, the best method rule must be applied. (Treas. Reg. §1.482-1(c).) The best method rule considers the degree of comparability (functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed) and the quality of data and assumptions used (completeness and accuracy of the underlying data; reliability of the assumptions made; and sensitivity of the results to the possible deficiencies in the data and assumptions) in the analysis. (Treas. Reg. §1.482-3(c)(3)(i).)

For purposes of comparing controlled and uncontrolled transactions, the following factors are relevant to the resale price method. (Treas. Reg. §1.482-3(c)(3)(ii)(C).) These include:

- Inventory levels, turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;
- Contractual terms (e.g., scope and terms of warranties, sale or purchase volume, credit terms and transport terms);
- Sales, marketing, advertising programs and services, including promotional programs, rebates and co-operative advertising;
- Level of the market (e.g., manufacturer, distributor, wholesaler, retailer or customer); and
- Foreign currency risks.

Again, the resale price method is typically used when the tested party is a distributor. Comparability under this method is particularly dependent on similarities of functions performed, risks borne and contractual terms. Adjustments for significant differences that affect gross profit margins should be made to improve the reliability of the results.

e. Cost Plus Method

The cost plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit mark-up realized in comparable uncontrolled transactions. This method can be applied when the reseller adds substantial value to the tangible goods by physically altering the goods for resale. For this purpose, packaging, repackaging, labelling or minor assembly do not ordinarily constitute physical alteration.

If possible, appropriate gross profit mark-ups should be derived from comparable uncontrolled purchases and resales of the reseller of the controlled sale because similar characteristics are more likely to be found. Otherwise, an appropriate gross profit mark-up can be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group. (Treas. Reg. §1.482-3(d)(3)(A).)

The best method rule considers the degree of comparability (functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed) and the quality of data and assumptions used (completeness and accuracy of the underlying data; reliability of the assumptions made; and sensitivity of the results to the possible deficiencies in the data and assumptions) in the analysis.

For purposes of comparing controlled and uncontrolled transactions, the following factors are relevant to the cost plus method. (Treas. Reg. §1.482-3(d)(3)(ii)(C).) These include the:

- Complexity of manufacturing or assembly;
- Manufacturing, production and process engineering;
- Procurement, purchasing and inventory control activities;
- Testing functions;
- Selling, general and administrative expenses;
- Foreign currency risks; and
- Contractual terms (e.g., scope and terms of warranties, sale or purchase volume, credit terms and transport terms).

The cost plus method is typically used when the tested party is a manufacturer. Comparability under this method is particularly dependent on similarities of functions performed, risks borne and contractual terms. Adjustments for material differences that affect the gross profit earned should be made to improve the reliability of the results.

f. Comparable Profits Method

1. In General

The comparable profits method (CPM) relies on the development of an arm's length range of operating profits from a sample of comparables to serve as a basis for judging the reasonableness of a taxpayer's transfer pricing regime. The CPM evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability derived from uncontrolled taxpayers that engage in similar business activities under similar conditions. (Treas. Reg. §1.482-5(a).) These objective measures of reliability are called profit level indicators.

The CPM analysis is based on the hypothesis that the taxpayer can identify industries or lines of business that have clear arm's length profitability standards at any point in time and make adjustments for differences in risks, functions, facts and circumstances. In practice, heterogeneity of companies and the limited scope of public data makes the CPM a fairly blunt instrument.

What is compared is uncontrolled taxpayers engaged in similar business activities with other uncontrolled taxpayers under comparable circumstances. For purposes of determining whether or not the result of applying the CPM is the most reliable measure of an arm's length result, the best method rule, considering the degree of comparability (functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed) and the quality of data and assumptions used (completeness and accuracy of the underlying data;

reliability of the assumptions made; and sensitivity of the results to the possible deficiencies in the data and assumptions) in the analysis, is applied.

The greater the degree of comparability between the tested party and the uncontrolled taxpayer, the more reliable will be the results derived from the CPM. Comparability under this method is dependent on all relevant facts, including the:

- Lines of business
- Product or service markets involved
- Asset composition employed, including the nature and quantity of tangible assets, intangible assets and working capital
- Size and scope of the operations
- Stage in a business or product cycle

An operating profit represents a return for the investment of resources and assumption of risks. Although the above items are relevant, comparability under this method is also dependent on resources employed and risks assumed. Because resources and risks usually are directly related to functions performed, it is also important to consider functions performed. Because operating profit is usually less sensitive than gross profit to product differences, reliability under the CPM is not dependent upon the physical similarity between the products. (Treas. Reg. §1.482-5(c)(2)(iii).) Rather than product comparability, what is relevant is functional comparability.

As with all methods, adjustments are made for the differences that would materially affect the profit level indicators between the tested party and the uncontrolled taxpayer. Differences in the functions performed by the taxpayer and the comparables that require adjustment would include:

- Selling, general and administrative expenses
- Research and development expenses
- Carrying costs of inventory
- Time value of accounts payable granted by suppliers
- Carrying costs of accounts receivable extended to customers.

2. Determination of an Arm's Length Result

Under the CPM, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator (see part 5 below) was equal to that of an uncontrolled comparable. This is the comparable operating profit. Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable, relevant business activity for which data incorporating the controlled transaction is available.

To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the profit level indicators of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result. (Treas. Reg. §1.482-5(b)(1).)

3. Tested Party

The tested party will be 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. Consequently, in most cases, the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables. (Treas. Reg. §1.482-3(b)(2)(i).) The tested party's operating profit must first be adjusted to reflect all other allocations pursuant to IRC §482. (Treas. Reg. §1.482-3(b)(2)(ii).)

4. Arm's Length Range

The arm's length range is established by using comparable operating profits derived from a single profit level indicator. (Treas. Reg. §1.482-5(b)(3).)

If the degree of comparability is not consistently high throughout the sample or if some relevant differences cannot be adjusted for, the boundaries of the arm's length range are narrowed. For example, the range may be narrowed by limiting the range to the results remaining within the 25th and 75th percentiles of the sample. (Treas. Reg. §1.482-5(b)(3).) Any statistically valid method may be applied to narrow the arm's length range.

5. Profit Level Indicators

Profit level indicators are ratios that measure relationships between profits and costs incurred or resources employed. A variety of profit level indicators can be calculated in any given case. Whether use of a particular profit level indicator is appropriate depends upon a number of factors, including the:

- Nature of the activities of the tested party;

- Reliability of the available data with respect to uncontrolled comparables; and
- Extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length, taking into account all facts and circumstances.

The profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two income years. This analysis must be applied in accordance with the multiple year analysis as described in the general section of Treas. Reg. §1.482-1.

Profit level indicators that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the:

- Rate of return on capital employed;
- Financial ratios, including the ratio of operating profit to sales and the ratio of gross profit to operating expenses; and
- Other profit level indicators. (Treas. Reg. §1.482-5(b)(4).)

Profit level indicators based solely on internal data may not be used because they are not objective measures of profitability derived from operations of uncontrolled taxpayers engaged in similar business activities under similar circumstances. (Treas. Reg. §1.482-5(b)(4)(iii).)

Treas. Reg. §1.482-5(d) provides definitions of the financial ratios to apply, while Treas. Reg. §1.482-5(e) provides examples of the CPM. Refer to these regulation sections for more detailed information on the CPM.

g. Profit Split Method

1. In General

The profit split method evaluates 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. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available. This is called the relevant business activity. (Treas. Reg. §1.482-6(a).)

In general, a profit split method may be approached with a three-step process:

- Determine the combined profit of commonly controlled parties from activities relating to the transactions between the two parties
- Split the combined profit between the two parties based on some formulary basis
- Derive transfer prices for transactions between the two parties consistent with the formulary allocation of profits

The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed and resources employed by each participant in the relevant business activity, consistent with the comparability provisions Treas. Reg. §1.482-1(d)(3). (Treas. Reg. §1.482-6(b).) That is, consider the degree of comparability, e.g., functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed. (Treas. Reg. §1.482-1(d)(1).)

The allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity. The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given taxable year, one member of the group may earn profit while another incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. (Treas. Reg. §1.482-6(b).)

The profit split method is a formulary substitute for determining transfer prices. However, profit split methods establish transfer prices for specific transactions. The profits to be split directly relate to the transactions whose transfer prices are at issue. In contrast, formulary apportionment methods used by state taxing jurisdictions allocate a portion of total net income or loss to a particular state based on the corporation's unitary business performed in that state. Thus, profit split methods and formulary apportionment methods are distinguishable.

As provided in Treas. Reg. §1.482-6(c), the profit split method is applied using one of two alternative approaches:

- Comparable profit split method
- Residual profit split method

Treas. Reg. §1.482-6(c)(3)(iii) provides examples of both the comparable profit split method and the residual profit split method. Refer to these regulation sections for more detailed information on the profit split methods.

2. Comparable Profit Split Method

A comparable profit split method is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to the controlled taxpayers' relevant business activity. Under this method, each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

The comparable profit split method compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. The degree of comparability is determined in the same manner at that used for the CPM. (Treas. Reg. §1.482-6(c)(2)(B)(1).)

For purposes of determining whether the results derived from the application of this method are the most reliable measure of an arm's length result, the best method rule must be applied. (Treas. Reg. §1.482-1(c).) The best method rule considers the degree of comparability (functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed) and the quality of data and assumptions used (completeness and accuracy of the underlying data; reliability of the assumptions made; and sensitivity of the results to the possible deficiencies in the data and assumptions) in the analysis.

Thus, the greater the degree of comparability between the tested party and the uncontrolled taxpayer, the more reliable will be the results. Comparability under this method is dependent on all relevant facts, including the:

- Lines of business;
- Product or service markets involved;
- Asset composition employed, including the nature and quantity of tangible assets, intangible assets and working capital;
- Size and scope of the operations; and
- Stage in a business or product cycle.

In addition to the above relevant items, comparability under this method is also dependent on resources employed and risks assumed. Because resources and risks usually are directly related to functions performed, it is also important to consider functions performed. Reliability under this method is not dependent upon the physical similarity between the products. What is relevant is functional comparability, not product comparability.

When evaluating data and assumptions within the best method rule, consider:

- The reliability of the allocation between the relevant business activity and the participant's other activities of the costs, income and assets; and
- The degree of consistency in accounting practices that materially affect the items that determine the amount and allocation of operating profit between the controlled and uncontrolled taxpayers.

3. Residual Profit Split Method

Under this method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following this two-step process:

- Allocate income to routine contributions; and
- Allocate residual profit.

A. ALLOCATE INCOME

The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or similar kind as those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangible property that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the six methods discussed in Treas. Reg. §1.482-3.

B. ALLOCATE RESIDUAL PROFIT

The allocation of income to the controlled taxpayer's routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present, there normally will be an un-allocated residual profit after the allocation of income described in A above. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative business activity that was not accounted for as a routine contribution. The relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property.

Alternatively, the relative market value of intangible contributions may be estimated by the capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property of all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of intangible contributions. If the intangible property contributed by one of the controlled taxpayers is also used in other business activities, such as transactions with other controlled taxpayers, an appropriate allocation of the value of the intangibles must be made among all the business activities in which it is used. (Treas. Reg. §1.482-6(c)(3)(i)(B).)

In determining whether or not the result of applying this method is the most reliable measure of an arm's length result, the best method rule, considering the degree of comparability (functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed), and the quality of data and assumptions used (completeness and accuracy of the underlying data; reliability of the assumptions made; and sensitivity of the results to the possible deficiencies in the data and assumptions) in the analysis must be applied.

When evaluating data and assumptions within the best method rule, consider:

- The reliability of the allocation between the relevant business activity and the participant's other activities of the costs, income and assets;

- The degree of consistency in accounting practices that materially affect the items that determine the amount and allocation of operating profit between the controlled and uncontrolled taxpayers; and
- The reliability of the data used and the assumptions made in valuing the intangible property contributed by the participants.

In particular, if capitalized costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate. This is because the costs of developing the intangibles may not be related to its market value. The calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may also affect the reliability of the analysis. And finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

h. Unspecified Methods

Where a controlled group of corporations have vertically integrated industries in which sales take place only between the related parties; where almost the entire output of a company is sold to a related party; or where it is determined that there are no acceptable comparables for any of the methods to establish an arm's length price, the regulations allow that a variation of the methods or "unspecified methods" be used, subject to the best method rule.

Any unspecified method that is used must apply the general principles of the Treas. Reg. §1.482-1(c), best method rule. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it.

For example, the CUP method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled transaction. Thus, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profit that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.

As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. Thus, in accordance with the comparability standard, to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used. (Treas. Reg. §1.482-3(e)(1).)

The regulation provides the following example: Assume that Amcan, a United States company, produces unique vessels for storing and transporting toxic waste, toxicans, at its United States production facility. Amcan agrees by contract to supply its Canadian subsidiary, Cancan Corporation, with 4000 toxicans per year to serve the Canadian market. Prior to entering into the contract with Cancan, Amcan had received a bona fide offer from an independent Canadian waste disposal company, Cando Ltd., to serve as the Canadian toxican distributor, purchasing a similar number of toxicans at a price of $5,000 each. If the circumstances and terms of the Cancan supply contract are sufficiently similar to those of the Cando offer, or sufficiently reliable adjustments can be made for differences between them, then the Cando offer price of $5,000 may provide reliable information indicating that an arm's length consideration under the Cancan contract will not be less than $5,000 per toxican. (Treas. Reg. §1.482-3(e)(2).) Note that the bona fide offer from Cando does not create a CUP because there is no actual uncontrolled transaction, only a possible deal with Cando.

The regulations do not provide any further guidelines for the use of this method and it is basically left up to the taxpayer, the auditor, and the economist to determine an arm's length price. This is a "catch all" method which includes many types of financial analyses.

If an unspecified method is being applied, it is advisable to use more than one form of financial analysis. For example, in *E.I. Dupont de Nemours and* Company, 608 F2d 445 (Ct.Cl. 1979), the IRS determined an arm's length price by using a 50-50 profit split approach, and the court found such an approach reasonable.

The IRS's expert witnesses analyzed the ratio of operating income to operating expenses for more than 121 distributors of a variety of products from different industries. Based on this analysis, the IRS determined an average ratio for each industry. The "Berry" ratio for DuPont's subsidiary was so far outside of the range of any of the other averages that the court was convinced that there was a distortion of income and that the profit split approach used by the IRS was reasonable.

i. Coordination with Intangible Property Rules

The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property. This is referred to as an embedded intangible. Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. However, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and the uncontrolled comparables. (Treas. Reg. §1.482-1(d)(3)(v).) For example, because product comparability has the greatest effect on an application of the CUP method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the CUP method.

The effect of the embedded intangibles on comparability is determined under the principles described in Treas. Reg. §1.482-4. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible, other than in connection with the resale of the item, it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, then the arm's length consideration for the transfer of that right must be determined separately under the rules with respect to the transfer of intangible property.

j. Summary

1. Treas. Reg. §1.482-3 contains the allowable methods used to determine an arm's length price for the transfer of tangible property. The six methods are the: CUP method, resale price method, cost plus method, comparable profits method, profit split method and unspecified methods. These methods are also no longer required to be applied in a strict order.
2. The determination of which method is the most reliable to apply is based on the best method rule. The best method rule looks to a standard of comparability, and the completeness and accuracy of the underlying data and assumptions, used in the pricing method analysis.
3. The CUP method is used in very limited circumstances, and is most effective for fungible goods or at a stage where intangibles are not a factor in the sale of the tangible property.

4. The resale price and cost plus methods are somewhat similar in application, because each is applied at the gross profit level rather than at the sales price level. The resale price method is used primarily for distributors of tangible property, while the cost plus method is primarily used for manufacturers of tangible property.
5. The CPM relies on the development of an arm's length range of operating profits from a sample of comparables to serve as a basis for judging the reasonableness of a taxpayer's transfer pricing regime. Profit level indicators are used as objective measures of an arm's length result. Under the CPM rather than the product comparability method, functional comparability is relevant.
6. The profit split method is determined by allocating the combined operating profit or loss of the relevant business activity based on the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The relative value of the controlled taxpayers' contribution to the relevant business activity is determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity. Treas. Reg. §1.482-6 provides two separate profit split methods, the comparable profit split method and the residual profit split method.
7. The comparable profit split method is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to the controlled taxpayers' relevant business activity. Under this method, each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity. The degree of comparability is determined in the same manner at that used for the CPM. The functions performed, not product comparability, is relevant for purposes of comparability.
8. Under the residual profit split method, combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers using a two-step process where first, income is allocated to the controlled parties based on the routine contributions each made with respect to the transaction. Then, any remaining net profit is divided among the controlled taxpayers based on some reasonable method.
9. If none of the five specified methods is appropriate, the regulations allow for the use of an unspecified method. While not specified in the regulations, any reasonable method may be used to determine an arm's length price. If this method is used, the application of the best method rule continues to apply. And finally, if the taxpayer uses this method, such fact must be disclosed on the taxpayer's timely filed return.

To the extent applicable, follow the IRS' Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

15.7 Transfer of Intangible Property Determination of an Arm's Length Price

Contents:

a. Overview of the Regulations

1. Regulations

The 1994 regulations are the first regulations issued with respect to intangible property since the commensurate with income standard was enacted with the Tax Reform Act of 1986. Treas. Reg. §1.482-4(a) states that the arm's length amount charged in a controlled transfer of intangible property must be determined under one of four methods. The four methods that can be used to determine the arm's length price for the transfer of intangible property include the:

- Comparable Uncontrolled Transaction (CUT) Method
- Comparable Profits Method
- Profit Split Method
- Unspecified Methods

Before each method can be discussed in detail, the overall structure of the regulations pursuant to IRC §482 should be reviewed. Treas. Reg. §1.482-1 provides the general terms to be applied when determining the intercompany transfer price. This regulation describes the best method rule, comparability and the arm's length range. Treas. Reg. §1.482-4 addresses methods to determine taxable income in connection with a transfer of intangible property and lists the four methods available for determining a price with respect to intangible property. It also discusses in detail two of the four methods.

Treas. Reg. §1.482-5 specifically explains the comparable profits method, while Treas. Reg. §1.482-6 explains the profit split method. The comparable profits and profit split methods apply to the transfer of both tangible and intangible property. Treas. Reg. §1.482-4(d) discusses the unspecified methods with respect to the transfer of intangible property. However, Treas.

Reg. §1.482-4(d) is analogous to Treas. Reg. §1.482-3(e), which discusses the unspecified methods with respect to the transfer of tangible property. The remaining method to be discussed, the comparable uncontrolled transaction method, is discussed in this section.

Treas. Reg. §482-2A(e)(1)(iv), with respect to tangible property, made it possible to apply the appropriate pricing methods to product lines or groupings, or to use sampling methods where useful. This concept remains in the 1994 regulations, as Treas. Reg. §1.482-1(f)(2)(iv) and applies to both the transfer of tangible and intangible property.

Although the particular requirements differ for each method, there are basic similarities among them. For each method, comparable transactions must be found with which to compare the controlled transactions. For either method, the circumstances of the uncontrolled transaction must be sufficiently similar to the circumstances of the controlled transactions. Also, adjustments must be made which have a reasonable and ascertainable effect on the price or profit of the comparables.

Pursuant to the 1994 regulations, the arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods. Each method must be applied in accordance with the general provisions of Treas. Reg. §1.482-1, including the best method rule, the comparability analysis and the arm's length range. However, the use of inexact comparables is allowed within all the pricing methods. The arm's length consideration for the transfer of an intangible must be commensurate with the income attributable to the intangible asset. Periodic adjustments to agreements with respect to the transfer of an intangible asset that exceeds one year must also be considered. (Treas. Reg. §1.482-4(a).)

2. Cost Sharing Regulations

The IRS spends significant efforts drafting general transfer pricing methods into the cost sharing regulations. Currently, Treas. Reg. §1.482-7 covers the methods to determine taxable income in connection with a cost sharing arrangement.

The cost sharing rules are briefly discussed in WEM 15.7(f). For complete details and examples, see Treas. Reg. §1.482-7.

b. Intangible Property Defined

Treas. Reg. §1.482-4(b) contains a very broad definition of intangible property. For purposes of IRC §482, an intangible asset is an asset that comprises any of the following items and has substantial value independent of the services of any individual:

- Patents, inventions, formulae, processes, designs, patterns or know-how;
- Copyrights and literary, musical or artistic compositions;
- Trademarks, trade names or brand names;
- Franchises, licenses or contracts;
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- Other items, if their value is derived from its intellectual content or any other intangible properties, rather than from their physical attributes.

c. Comparable Uncontrolled Transaction Method

The method described as most likely to result in an accurate estimate of an arm's length price is the comparable uncontrolled transaction (CUT) method. This method works by making a comparison of the amount charged for the intangible asset in a controlled transaction to the amount charged for the intangible asset in an independent transaction.

The CUT method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. (Treas. Reg. §1.482-4(c)(1).) In determining whether or not the result of applying the CUT method is the most reliable measure of an arm's length result, the best method rule must be applied. The principles of the best method rule are contained in Treas. Reg. §1.482-1(c). The best method rule considers the degree of comparability (functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed) and the quality of data and assumptions used (completeness and accuracy of the underlying data; reliability of the assumptions made; and sensitivity of the results to the possible deficiencies in the data and assumptions) in the analysis.

The intangible property and circumstances of the controlled and uncontrolled transactions must be the same or substantially the same. The circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method. However, the reliability of the analysis will be reduced. (Treas. Reg. §1.482-4(c)(2)(ii).)

In addition to the best method rule, two additional factors are relevant to the CUT method for purposes of determining comparability. Both the controlled and uncontrolled transaction with respect to the intangible property must:

- Be used in connection with similar products or processes within the same general industry or market; and
- Have a similar profit potential. (Treas. Reg. §1.482-4(c)(2)(iii)(B).)

The profit potential of an intangible is most reliably measured by directly calculating the net present value of the benefits to be realized, based on prospective profits to be realized or costs to be saved, through the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed and other relevant considerations. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. (Treas. Reg. §1.482-4(c)(2)(iii)(B)(ii).)

Treas. Reg. §1.482-4(c)(2)(iii)(B)(2) provides that, if the information necessary to directly calculate the net present value of the benefits to be realized is unavailable, and the need to reliably measure profit potential is reduced because the potential profits are relatively small in terms of total amount and rate of return, a comparison of profit potential may be based upon these factors:

- The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited.
- The stage of development of the intangible in the market in which the intangible will be used, including necessary government approvals, authorizations or licenses, whenever applicable.
- Rights to receive updates, revisions or modifications of the intangibles.
- The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries.
- The duration of the license, contract or other agreement, and any termination or renegotiation rights.
- Any economic and product liability risks to be assumed by the transferee.

- The existence and extent of any collateral transactions or ongoing business relationships between the transferee and the transferor.
- The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

The CUT method is the preferred method within the regulations. It is based on the use of specific uncontrolled transactions and requires the development of third party pricing data for specific transactions. The CUT method takes the interests of both the transferee and the transferor into account because the third party terms reflect the outcome of negotiations between a willing transferee and transferor. In theory, the CUT method allocates risk in the same manner as would the market. Also, the CUT method derives a transfer price directly from prices obtained from transactions in which one company transfers the same or similar intangible to an unrelated party. And finally, under the CUT method, the similarity of the intangible property generally will have the greatest effect on comparability.

d. Special Rules

1. Periodic Adjustments

If intangible property is transferred under an agreement covering more than one income year, the amount charged in each income year is subject to periodic adjustments to ensure that the commensurate with income standard has been met. The determination of the arm's length amount for an intangible will be made every year. Accordingly, the determination that the consideration for the intangible asset in an earlier year was an arm's length amount will not preclude an IRC §482 adjustment for consideration in a subsequent taxable year.

There are five exceptions for which periodic adjustments will not be made. These include when:

- Both the controlled transaction and the uncontrolled comparable involve the same intangible.
- The CUT method is applied using comparable intangible property, and the actual profits attributable to the intangible are not less than 80 percent nor more than 120 percent of the projected profits. (Treas. Reg. §1.482-4(f)(2)(B).)
- A method other than the CUT method is the basis for the amount charged in the controlled transaction, and actual profits are not less than 80 percent nor more than 120 percent of the projected profits. (Treas. Reg. §1.482-4(f)(2)(C).)

- The actual profits realized are less than 80 percent or more than 120 percent of the projected profits due to extraordinary events that were beyond the control of the controlled taxpayers, and all other requirements of Treas. Regs. §§1.482-4(f)(2)(B) or (C) are satisfied.
- The consideration for each year of the five-year period beginning with the first year in which substantial periodic consideration is required to be paid is at arm's length.

2. Ownership of Intangible Assets

If an owner of the rights to exploit an intangible asset transfers such rights to a related person, the owner must receive an arm's length amount in consideration. The legal owner of a right to exploit an intangible asset ordinarily will be considered the owner of the intangible asset for purposes of IRC §482. Legal ownership may be acquired by operation of law, through a patent, or by contract, e.g., licensing agreement. (Treas. Reg. §§1.482-4 through 1.482-6.)

In addition, an intangible asset may have multiple legal owners. Because the right to exploit an intangible can be subdivided in various ways, a single intangible may have multiple owners for purposes of this section. Thus, for example, the owner of a trademark may license to another person for the exclusive right to use that trademark in a specified geographic area for a specified period of time while otherwise retaining the right to use the intangible. In such a case, both the licensee and the licensor will be considered owners with respect to their respective exploitation rights.

In the case of an intangible asset that is not legally protected, the person that bore the largest portion of the costs of developing the intangible asset will be considered the owner.

3. Consideration Not Artificially Limited

The arm's length consideration for the controlled transfer of an intangible is not limited by the consideration paid in any uncontrolled transactions that do not meet the requirements of the CUT method. Similarly, the arm's length consideration for an intangible is not limited by the prevailing rates of consideration paid for the use or transfer of intangibles within the same or similar industry. (Treas. Reg. §1.482-4(f)(5).)

4. Lump Sum Payments

If an intangible is transferred in a controlled transaction for a lump sum payment, the payment amount must be commensurate with the income attributable to the intangible property. A lump sum payment is commensurate with income in an income year if the equivalent royalty amount for that income year is equal to an arm's length royalty. The equivalent royalty amount for an income year is the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible property, or the period covered by an agreement, if shorter, taking into account the projected sales of the licensee as of the date of the transfer. (Treas. Reg. §1.482-4(f)(6).)

Thus, determining the equivalent royalty amount requires a present value calculation based on the lump sum, an appropriate discount rate, and the projected sales over the relevant period. The equivalent royalty amount is also subject to periodic adjustments to the same extent as an actual royalty payment would be pursuant to a license agreement.

e. Cost Sharing Arrangements

1. In General

The U.S. began regulating cost sharing arrangements (CSA) in 1966. Since then, cost sharing regulations expanded significantly. The CSA rules began as a subparagraph to Treas. Reg. §1.482-2 and, in 1995 became standalone Treas. Reg. §1.482-7, covering the methods to determine taxable income in connection with a CSA. The Treas. Reg. is updated regularly (e.g., major amendments were introduced in 1992, 1995, 2005, 2009, and 2011). Accordingly, when dealing with CSA, refer to Treas. Reg. §1.482-7.

A CSA is an arrangement among controlled taxpayers to aggregate resources, while sharing risks, to develop intangibles and exploit such intangibles without the need to pay royalties.

Participants in a cost sharing arrangement agree to share the costs associated with developing intangibles in proportion to the reasonably anticipated benefits that they expect to receive from use of those intangibles. Each of the participants will be considered to own an interest in the intangible property that is developed. Although the IRS/FTB may make allocations to make each participant’s share of the costs equal to its share of the reasonably anticipated benefits, no other IRC §482 allocations will generally apply to intangibles developed and used under a qualified cost sharing agreement. Because costs, rather than a profit element, are being allocated, the presence of a qualified cost sharing agreement may result in a less difficult audit environment.

A taxpayer may only rely upon the cost sharing rules if the arrangement meets the requirements of a qualified cost sharing arrangement under Treas. Reg. §1.482-7. On the other hand, the IRS/FTB may apply the cost sharing rules to any arrangement that constitutes a cost sharing arrangement in substance, even though the arrangement does not meet all of the requirements set forth in the regulation.

2. Cost Sharing Arrangements

Initially, the regulations referred to a valid agreement as a "bona fide cost sharing arrangement," then as a "qualified cost sharing arrangement," and, most recently, simply as a "cost sharing arrangement" subject to substantive and administrative requirements. (Treas. Reg. §1.482-7(b).)

A CSA is a written agreement between controlled participants to share the costs and risks of developing cost shared intangibles in proportion to their reasonably anticipated benefit (RAB) share. The primary function of the arrangement is to establish the terms of co-ownership of the developed intangibles.

In a CSA, the controlled participants make economic contributions of two types:

- Cost contributions – Mutual commitments to prospectively share intangible development costs in proportion to their RAB from exploitation of the cost shared intangibles
- Platform contributions (PCTs) – To provide any existing resources, capabilities, or rights that are reasonably anticipated to contribute to developing cost shared intangibles

An arrangement is a CSA if, and only if, the requirements of the regulation are met. (Treas. Reg. §1.482-7(b).) To be a CSA, the arrangement must:

- Meet substantive requirements, all controlled participants must:
  a) Commit and engage in cost sharing transactions (CSTs).
  b) Allocate their intangible development costs (IDCs) in proportion to each participant RAB share.
  c) Have no further obligation to compensate other controlled participants for each other's non-overlapping interests in the cost sharing intangibles. (Treas. Reg. §1.482-7(b)(1).)
- Comply with administrative requirements (i.e., contractual, documentary, accounting, and reporting requirements set forth in Treas. Reg. §1.482-7(k). (Treas. Reg. §1.482-7(b)(2).)

- Enter into a platform contribution (PCT) on the date the PCT is "reasonably anticipated to contribute to developing cost shared intangibles." (Treas. Reg. §1.482-7(b)(3).)
- Divide interests in a cost shared intangible (CSI) into non-overlapping, perpetual, and exclusive interest on territorial, field of use, and other divisional bases subject to specified requirements. (Treas. Reg. §1.482-7(b)(4).)

An arm's length consideration is required when a controlled participant's interest are changed as a result of transactions between each other, entrance of a new or departure of an existing participant, or when a service is provided by a controlled taxpayer, as opposed to a controlled participant. (Treas. Reg. §1.482-7(a)(3).)

3. Controlled Participant

A controlled participant means a controlled taxpayer that is a party to the contractual agreement that underlies the CSA, and that reasonably anticipates that it will derive benefits from exploiting one or more cost shared intangibles. (Treas. Reg. §1.482-7(j).)

A controlled taxpayer means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayer. Uncontrolled taxpayer means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests. (Treas. Reg. §1.482-1(i)(5).)

See Treas. Reg. §1.482-7(j)(ii), examples 1 and 2, illustrating the definition of controlled participants.

4. Intangible Development Costs

IDCs are determined by reference to the scope of the intangible development activity (IDA). IDCs include all costs, in cash or in kind (including stock-based compensation), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation of the CSA. (Treas. Reg. §1.482-7(d)(1)(iii).)

IDA means the activity, under the CSA, of developing or attempting to develop reasonably anticipated cost shared intangibles. The scope of the IDA includes all of the controlled participants' activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost shared intangibles. (Treas. Reg. §1.482-7(d)(1)(i).)

5. Reasonably Anticipated Benefits

A controlled participant's reasonably anticipated benefits (RABs) means the "benefits" that reasonably may be anticipated to be derived from exploiting cost shared intangibles. In this definition, benefits means the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles. (Treas. Reg. §1.487-7(j)(1)(i).)

See examples under Treas. Reg. §1.482-7(j)(1)(i) illustrating these definitions.

6. Platform Contributions

The 2009 Temporary Regulations introduced "platform contribution transaction." The 2011 final Regulations adopted the change, defining a "platform contribution" as "any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles." (Treas. Reg. §1.482-7(c)(1).)

In a platform contribution transaction, each other controlled participant (PCT payor) is obligated to, and must in fact, make arm's length payments (PCT payments) to each controlled participant (PCT payee) that provides a platform contribution. See examples 1 and 2 under Treas. Reg. §1.482-7(c)(5), illustrating a PCT.

f. Summary

1. Treas. Reg. §1.482-4 contains allowable methods used to determine an arm's length price for the transfer of intangible property. The four methods are the: CUT method, comparable profits method, profit split method and unspecified methods.
2. The determination of which method is the most reliable to apply is based on the best method rule. The best method rule looks to a standard of comparability, and the completeness and accuracy of the underlying data and assumptions, used in the pricing method analysis.
3. Intangible property is defined broadly to include any asset that derives its value from its intellectual content or from other intangible properties.
4. The CUT method is described as most likely to result in an accurate estimate of an arm's length price. The CUT method works by making a

comparison of the amount charged for the intangible asset in a controlled transaction to the amount charged for the intangible asset in an independent transaction. The CUT method was not present in the 1968 regulations, but became established in the 1994 regulations.
5. If intangible development costs have been appropriately shared under the terms of a qualified cost sharing agreement, then no other IRC §482 allocation will generally be required with respect to the intangibles developed under such an arrangement.

To the extent applicable, follow the IRS' Internal Revenue Manuals (e.g., IRM 4.61 Internal Program Audit Guidelines) and actions that deal with passage of tax legislation, promulgation of regulations, and establishment of the International Enforcement Program. When using these federal sources, account for differences in federal and state law and terminology.

15.8 Tangible and Intangible Property, Examination Guidelines

Contents:

a. Introduction

When examining a multinational corporation for a potential pricing issue, it is important to be as organized as possible, and possess a working knowledge of IRC §482 and the Treas. Reg. §1.482-1 through TR §1.482-9.

This section provides some general examination guidelines to apply when auditing intercompany pricing issues. This section is in no way a complete grouping of audit steps to be performed during an audit. Transfer pricing issues depend on the facts and circumstances of the case and each audit plan should be revised accordingly. This section simply provides some audit steps that may be useful.

Because R&TC §25114 directs FTB to examine water's-edge returns for potential noncompliance, an evaluation of potential intercompany pricing issues in required for taxpayers filing on a water's-edge basis. There are no bright-line tests to determine the materiality of a potential pricing issue. Accordingly, you need to evaluate the taxpayer’s facts and circumstances to determine whether an IRC §482 pricing audit should be pursued. This analysis should be performed as early in the audit cycle as possible to ensure that there is enough time left within the statute of limitations to develop the case if the issue is pursued.

Should a pricing issue be pursued, the focal point of your inquiry should be to determine the key facts of the taxpayer's business. A comprehensive understanding of the nature of the business activities of the taxpayer and the related parties that have intercompany transactions with the taxpayer is needed. Until this is known, no conclusions can be drawn about the taxpayer's intercompany transfer pricing policies.

Under the regulations, comparability factors to evaluate include:

- Functions performed by the entities and the associated resources employed;
- Relevant contractual terms of the transactions;
- Risks incurred by the various affiliated entities;
- Relevant economic conditions of the various markets; and
- Any items of property provided or services performed.

To make a proper determination, obtain all the relevant facts and understand the circumstances related to the taxpayer and its industry.

b. Organization of the Examination

Determine whether the related members engaged in such a transaction are dealing at arm's length. Simply stated, an arm's length price is a price at which a willing buyer would pay a willing seller in an open market. This seemingly simple concept has caused some of the most complex problems found in tax administration.

A challenge to pricing cases is the difficulty of finding comparable transactions with which to compare the related transactions under examination. This is especially true where the product is unique and there is little competition in the taxpayer's market. When this occurs, it requires reliance on more subjective criteria and the answer to the question "what is the arm's length price" becomes more complicated. Regardless, before arguments concerning the arm's length price can even begin, you need to show that there is a basis for making the allocation in the first place.

The key to a well-supported adjustment is to organize and develop the facts that will demonstrate that there is a problem that needs to be corrected. It is not necessarily the quantity of information, but the quality of the evidence gathered and its relevance to the pricing issues.

c. Examination Strategy

The organization of a pricing case can be narrowed down to the following tasks. This can provide a basis for an audit plan. These tasks include:

1. Determine whether there is a problem. There are instances where a transfer pricing problem is so severe that it clearly stands out (for example, products are transferred to a foreign distributor for cost plus a nominal mark-up, and immediately resold to third parties at a

tremendous profit). However, in many cases the problem can be more subtle and may not be evident until some basic analysis of the taxpayer's return, the financial statements and selected accounts is performed.

2. Gather as much information as possible not only related to the transactions, but related to the taxpayer and the industry as well. This sounds like a lot, but there is no quick way to set up a pricing case, and it is sometimes difficult to know in the early stages of an IRC §482 audit what information can be of the most value. For example, a pricing method cannot generally be selected until you have developed a good understanding of the taxpayer's facts and circumstances, as well as information about potential comparables. But, depending upon the pricing method that is ultimately used, some types of information may become more relevant than other types. For example, if a cost-plus method is used, detailed information about the taxpayer's manufacturing processes and equipment will be important. This level of detail may not be necessary if a CUP method is used. Use of a profit split method may require additional information about a related party's research and development activities.
3. Develop enough basic or preliminary information to obtain a very good understanding of the terms of the transactions themselves, the activities of the taxpayer and its related parties, and how the industry operates. This information will need to be gathered regardless of the situation. Based on that information, you can begin to evaluate what the best pricing method, and focus subsequent information gathering on items that will be relevant for application of that method. If facts are developed which indicate that another pricing method may be more appropriate, refocus the fact gathering in light of the new method.
4. Locate and define comparable companies and transactions with which you can compare the taxpayer's situation. This calls for a lot of research and may also involve contacting third parties for information and testimony. If an economist is assigned to the audit, the economist can assist with this responsibility. Coordination between the economist and auditor is essential. Development of information concerning the activities of a comparable company is primarily an audit function, but the economist will provide input regarding what information is needed to evaluate comparability.
5. Determine an arm's length price or standard. If an economist is assigned to the case, the economist will assist with this task.

d. Preliminary Examination Techniques

1. Analysis of Financial Statements and Other Data

Why is it so important to read and analyze a company's financial statements? It makes a good starting point. Even though we have the tax return, there may be disclosures in the notes to the financial statements that will help you decide whether to continue pursuing a pricing issue. There are also times where you may receive a financial statement of an affiliated company, such as a foreign parent or subsidiary that was neither included in a combined report with the taxpayer nor filed a state or federal return of its own. Differences discovered in the statements determined by divisions, product segments or foreign sourced income can also point to potential pricing issues.

You gain very little understanding of what financial statements tell about a company by simply noting the dollar amount for each item. To understand what the numbers mean, relate them in some way either to each other, to figures for similar or related items in other statements, or to industry standards. The purpose of performing an analysis is to make comparisons to discover different trends experienced by the company. An analysis of several different taxable years should be performed, commonly called a trend analysis or comparative analysis. In addition, an industry or ratio analysis should be performed, where certain financial ratios of the taxpayer's industry are compared to the taxpayer's ratios to determine any potential problem areas. Both of these types of analysis should be performed.

Perform a preliminary ratio and trend analysis to evaluate a potential pricing noncompliance prior to recommending the case for an IRC §482 audit. However, as the audit progresses and you obtain more data, the preliminary analyses can be refined to reflect more specific product line financial data and more exact comparables.

2. Ratio Analysis

You should include several ratios in an analysis. Ratios help to determine problem areas at a glance and it is easier to compare those with either other individual companies or industry ratios. For pricing cases the following ratios are particularly important:

- Gross profit ratio
- Berry ratio (gross profit/operating expenses)
- Return on assets
- Return on sales

- Inventory turnover rate
- Accounts receivable turnover rate

Ratios are most helpful when reviewed as a whole, rather than reviewing each separately. Ratio formulas are available in many reference materials. An intermediate accounting book will contain all the ratios with a complete explanation of the purpose of each type of ratio. For example, you may notice that an entity's gross profit ratio has been declining over a period of years. You may also have determined that a company very similar to the taxpayer shows a much larger gross profit ratio each year.

3. Trend Analysis

The objective in performing a trend analysis of financial statements or selected accounts is to look for significant fluctuations in the taxpayer's income producing activity. It also can be used to detect fluctuations in the balance sheet. A trend analysis is usually performed over a minimum of three years. For selected accounts, such as accounts receivable and inventory, a trend analysis is performed on a month-to-month basis.

There are two ways to present a trend analysis and usually both are performed: the horizontal analysis and the vertical analysis. The horizontal analysis compares one income year amount to a prior income year amount and shows the percentage of one period's amount over or under the same item in the prior period. This is calculated for each component of the financial statements. The vertical analysis calculates the percentage of each component part of a statement to the total in that statement compared to that of the last period. Examples of these calculations are also shown and explained in an intermediate accounting book.

4. Basic Information Required

Obtain balance sheets and profit and loss statements for each of the related entities involved in the questioned transactions, as well as the consolidating working papers. Preferably, these statements should be included in or reconciled to a certified audit report. It is very important to determine the gross profit reported by each entity from the transactions in question, as well as the entities' allocated share of the selling, general and administrative expenses.

At a minimum, these statements should cover the years under examination, although an attempt should be made to obtain as many years as possible to derive a financial history of the related entities. A comparative analysis should be made of all statements obtained. Also obtain the interim monthly statements, if possible, including company allocations of income and expenses by product line or type. Do not be content with summarized, year-end financial reports.

Copies of invoices should be obtained, although in the case of a large volume of sales, a representative sample of invoices will be sufficient. Copies of price lists, including all relevant price changes used during the income years of examination should be obtained. A schedule of rebates or price protection allowances should be obtained as well, since these have the effect of a price reduction.

Be sure to obtain all written agreements between the related parties, not just the distribution agreement. Also obtain cost sharing, financing and special agreements. Find out if any terms have been changed, and if so, whether there is internal correspondence or other written evidence to substantiate the term changes.

You must study the operations of the taxpayer, and if possible, the operations of its foreign affiliates. You must also become familiar with the industry in which the taxpayer is involved and industry-wide practices. This is to help determine whether or not the taxpayer is operating in a prudent business manner. Information to be obtained would include:

- Trade magazines relating to the taxpayer's business.
- Articles about the taxpayer written in various periodicals.
- An extensive review of the taxpayer's operations, e.g., a complete functional analysis.
- Reports on investigations of the taxpayer, e.g., United States Customs service import duty investigations or United States Department of Commerce anti-dumping investigations. Also, review taxing authorities' audit reports, e.g., other state or foreign governments.

Other preliminary information to obtain should include items such as prior audit files, internal audit reports, and SEC 10-K or 20-F filings. This is by no means an exhaustive list but it should give you a good idea of the type of development you will need.

The amount of the information needed is quite extensive, but is needed to determine which party bore the risk of the business and whether they were adequately compensated for that risk. For example, was the United States distributor responsible for currency fluctuations, warranty expense and product liability? If so, was adequate compensation made in the price from the manufacturer? Also, who bore the brunt of carrying excess inventory?

Were they adequately compensated for risk of inventory obsolescence, inventory carrying costs, etc.?

e. Account Analysis

Make an analysis of selected accounts listed in the general ledger to determine what expenses should be considered as adjustments for the comparable uncontrolled price (CUP) method, the resale price method, the cost plus method or the comparable uncontrolled transaction method. This analysis is important because if one of these methods is used, adjustments to the comparables gross profit may be necessary to arrive at an appropriate markup. For example, if the comparable company has different warranty risks or different shipping terms, adjustments for warranty and product liability expenses or freight-out charges may be necessary in order to make the transactions or profit margins more comparable.

Another reason to make an analysis of the accounts is to determine how expenses are allocated to the different product lines. A review of monthly reports (flash reports), budget variance reports and other management reports will show how expenses are allocated by division or department, and may give clues to potential problem areas.

f. Analysis of Foreign Affiliates

Secure records and other information concerning how the foreign affiliate treated the transactions under examination. Data sought should include how much profit, or loss, was recognized by the foreign affiliate on the sale, or resale, of the products; how the foreign affiliate recorded expenses and profits on products not sold to the taxpayer.

Documents sought should include the foreign affiliates' foreign income tax returns, the affiliates' financial statements, and if necessary, the affiliates' accounting records for the manufacturing and distribution costs for the products sold to the taxpayer.

g. Functional Analysis

For a pricing case, or any other IRC §482 case, perform a functional analysis. Many of the IRC §482 reference materials contain checklists of questions that relate to a specific function, e.g., manufacturing, marketing, that can be used when preparing Information Document Requests. It is appropriate here to define what a functional analysis is and to define its role within a transfer pricing examination.

The Internal Revenue Service's (IRS) Internal Revenue Manual (IRM) directs revenue agents to follow certain steps when a transfer price is examined under IRC §482. The first step, detailed below, is a preparation of a statement of facts. The second step is to determine what economically significant facts were performed in accomplishing the questioned transactions, and who performed them. This step is known as the functional analysis. The IRM further states that "...no facts regarding comparables...will be helpful unless it has been determined with accuracy just what should be measured." Only after this factual determination has been made can a method be selected and employed in arriving at an arm's length price.

Therefore, the role of the functional analysis is to:

Determine the facts with respect to a given transaction between the related parties, and set the stage for the choice of pricing method, by providing the framework within which comparable transactions may be determined.

The IRM states that the importance of the functional analysis cannot be overemphasized, and that virtually all IRC §482 cases can be reduced to the following questions:

- What was done?
- What economically significant functions were involved in doing it?
- Who performed each function?
- What is the measure of the economic value of each function performed by each party?
- What economic risks were assumed?
- Are there any valuable intangibles used in performing the given function?

So, what do you do with the functional analysis once it is done? Once the functions performed by entity have been identified, you can use the information to lay the groundwork for selecting comparables. You may also be able to identify where adjustments have to be made; e.g., warranties and terms of sale.

For example, you have determined, by reference to your functional analysis, that your taxpayer is a wholesale distributor of consumer durable goods that have a very low inventory turnover. You now know that you need to find other wholesale distributors bearing similar risks. Therefore, distributors of perishable goods or durable goods with very high inventory turnovers will not be your first choice for comparables because the risks are different from the taxpayer's situation.

h. Details of Questioned Transactions

After receiving and reviewing the preliminary information obtained during the examination, you should start to analyze the sales between the related entities. The IRM offers guidelines for this phase of the examination. A thorough study of the IRM is valuable because it offers a way to organize the examination. Taxpayers are also very aware of the IRM, and numerous articles have been written about it.

The starting point is to obtain reasonably detailed information concerning the questioned transactions as they actually happened. You must determine what products and related services or intangibles were involved. For example, in what form are the goods sold, e.g., in bulk, small packages, branded or unbranded, with how many units? At what prices were the goods sold? What credit terms were given? If the products are resold, determine at what prices and to whom. If the products were not resold, determine what happens with the product. The reason for this extensive analysis is to identify the areas you can compare and where you will have to adjust, depending on the pricing method that is used.

The guidelines state that if only a fairly limited number of products are involved and only a reasonably small number of separate sales, the details for each individual sale, and resale, should be obtained. If a large number of products or a large volume of sales are involved, grouping by product line or other form of consolidation may be used.

i. Determination of Intercompany Charge

It is important to obtain whatever information is available as to how the related entities arrived at the price or the charges that they used. It is not only necessary to find out what prices were charged, but also how and why it was decided to use that price rather than another price. Some of the information to be considered should include factors such as whether the intercompany price included a constant return to the reseller on certain expenses; whether the price included a consideration for services performed between the related parties; and whether there are considerations made for extraordinary expenses or contingencies, such as fluctuations of exchange rates.

In connection with determining the basis on which the price was calculated, you should find out which persons or group of persons made the decision, and arrange for an interview of those persons.

After learning how the intercompany prices are determined, an attempt should be made to check the validity of the method used by the taxpayer. For example, if a price to a related party was based on prices charged to unrelated parties, the independent transactions should be examined to determine whether they occurred under the same circumstances. Finally, determine whether the parties actually followed their own criteria.

An understanding of the functions performed in the controlled transaction is critical to determine whether the independent transactions are comparable. If you conclude that the method used by the taxpayer in arriving at the intercompany charges is not acceptable, the facts supporting your rejection should be clearly stated, and include analysis of any alleged comparables put forth by the taxpayer but not accepted by you.

j. Summary

1. To conduct a proper examination involving a pricing issue, you must be as organized as possible. In the early stages of the examination, you should contact the International Specialist to coordinate any assistance you will need from the legal division and an economist from the research and statistics group.
2. By familiarizing yourself with the requirements of the regulations, you should be able to determine most of the basic data you will need to properly document your case. By familiarizing yourself with the record maintenance requirements and related penalties, you will be better able to deal with uncooperative taxpayers.
3. The functional analysis is a method of determining the facts surrounding your controlled transaction prior to finding comparables and applying the appropriate pricing method. It is the first step in the proper interpretation and application of IRC §482.
4. See Treas. Reg. §1.482-9 for the appropriate standards and examples illustrating the application of the best method rule.