Chapter 18 Intercompany Transfer Pricing

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This chapter discusses Internal Revenue Code (IRC) §482 and Treasury Regulations (TR) §1.482-0 through TR §1.482-8. A working knowledge of IRC §482 is required to effectively examine a water's-edge combined report. You need to understand IRC §482 and its effect for California franchise and income tax purposes for a number of reasons. The IRC §482 rules apply primarily to transactions between unitary entities that do not file a combined report due to a water's-edge election. In general, an analysis of the potential intercompany transfer pricing issues is required for every audit of a water's-edge combined report. Applying the provisions of IRC §482 can be very difficult because the issue is factually intensive and comparable transactions may not be easy to find. Because of these difficulties, the application of IRC §482 is one of the most controversial tax areas.

This chapter discusses or provides: a comprehensive discussion of the regulations as they apply to various intercompany transactions; the history of the provisions; definitions of key terms; the interaction with other code sections; key aspects of the regulations finalized in 1994; numerous examples; Franchise Tax Board's specific audit responsibility; and examination guidelines.

Section 18.1 Introduction To Intercompany Transfer Pricing

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Revenue and Taxation Code §24725
Revenue and Taxation Code §25114
California Code of Regulations §25114
Internal Revenue Code §482

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Training Objectives:

This section of the chapter introduces the intercompany transfer pricing issue. When related corporations price intercompany transactions at a value that is not the value that would have been used by unrelated corporations, the value is considered not to be at "arm's length". When this occurs, an allocation may be required pursuant to Internal Revenue Code (IRC) §482. A working knowledge of IRC §482 is required to effectively examine a water's-edge combined report. At the end of §18.1, you will have a basis understanding of IRC §482, including the history of the provision, definitions of several key terms, interaction with other code sections and our specific audit responsibility.

a. Introduction

Revenue and Taxation Code (RTC) §24725 and §25114 authorize the Franchise Tax Board (FTB) to allocate income, deductions and credits amongst commonly controlled entities in order to prevent the evasion of tax, or to clearly reflect income when intercompany transactions occur. RTC §24725 and §25114 are the California counterparts to IRC §482.

You need to understand IRC §482 and its application for California franchise and income tax purposes for a number of reasons. The IRC §482 rules apply to transactions between unitary entities which do not file a combined report due to a water's-edge election, and to transactions between unitary and nonunitary entities since these entities are not included in the same combined report. Applying the provisions of IRC §482 can be very difficult because the issue is factually intensive and comparable transactions may not exist. As a result, application of IRC §482 is one of the most controversial tax areas.

When intercompany transactions occur between related corporations, the corporations can control the terms of the transactions in such a way as to generate a lower overall tax liability for the entire affiliated group. The theory present in IRC §482 is based on the "arm's length standard". In general, the concept of the arm's length standard is that when intercompany transactions occur between corporations that are owned or controlled by the same interests, the same price or terms should apply as if the transaction had occurred between unaffiliated corporations.[1] The arm's length price is the market price between unaffiliated corporations. In theory, if the arm's length standard is used, corporations would recognize net income(loss) in the taxing jurisdiction where the income(loss) was earned(generated).

Problems arise when a United States corporation sells goods to a foreign subsidiary at cost with no mark-up or a less-than-arm's-length mark-up. Most, if not all, of the profits from reselling the goods are reported abroad and are not taxed by the United States until the income is repatriated as dividend income. Further, if a foreign corporation sells goods to a United States subsidiary at cost plus a larger-than-arm's-length mark-up, the profit from reselling the goods in the

United States will be minimal, causing a net operating loss or minimal taxable income in the United States.

This section introduces you to the general concepts of intercompany transfer pricing pursuant to IRC §482. Section 18.2, Water's-Edge Manual describes the §482 rules that apply to intercompany loans and advance payments. Section 18.3, Water's-Edge Manual describes the §482 rules that apply to the intercompany performance of services. Section 18.4, Water's-Edge Manual discusses the §482 rules that apply to the intercompany usage of tangible property. Section 18.5, Water's-Edge Manual discusses the revisions caused by the regulations finalized in 1994. Section 18.6, Water's-Edge Manual discusses the §482 rules that apply to intercompany transfer of tangible property. Section 18.7, Water's-Edge Manual discusses the §482 rules that apply to intercompany transfer of intangible property. And finally, Section 18.8, Water's-Edge Manual discusses helpful guidelines to be used when auditing the transfer or use of tangible and intangible property.

b. History

Prior to 1986, IRC §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.[2]

Effective for income years beginning after December 31, 1986, the Tax Reform Act of 1986 (TRA86)[3] 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 §936(h)(3)(B)) the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

During the 1970s, Puerto Rico become a focal audit point of IRC §482 because of the interplay with IRC §936 provisions. As a result, in 1986, the TRA86 created the super-royalty provision. The Ways and Means Committee Report explained Congress felt it necessary because of concerns that United States taxpayers would develop extremely valuable intangibles in the United States and transfer them to manufacturing entities in low-tax jurisdictions for the purpose of avoiding the payment of United States tax. The result of the TRA86 was the establishment of the commensurate with income standard, which requires that the developer of an intangible asset receive an income stream which is proportionate to the value of the transferred intangible asset.[4]

During the 1980s, the perception continued to grow that both foreign and domestic corporations were abusively shifting income from the United States to lower taxing jurisdictions and that large amounts of income were escaping 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. The White Paper, published in Notice 88-123[5], contained concepts that would subsequently appear in proposed regulations, including how to apply the commensurate with income standard and record maintenance requirements.

On January 20, 1992, proposed regulations under IRC §482 were issued, which attempted to implement the commensurate with income standard. These proposed regulations were withdrawn and replaced with temporary and proposed regulations on January 21, 1993. The existing regulations, proposed and temporary, up to this point contained a hierarchy priority of the methods. That is the Internal Revenue Service (IRS) had to analyze the facts of the case and first determine whether the first method applied and before moving to the next method, demonstrate that the first method did not apply. It was typical for the IRS to continue through the available methods and ultimately end up applying an "other" or fourth method. However, much audit work was needed before the next method could be used.

On July 1, 1994, the proposed regulations were finalized and are effective for income years beginning after October 6, 1994. However, taxpayers can elect to apply the finalized regulations to any open income year. The finalized regulations more fully address intangible assets and also revised the rules related to tangible assets. The regulations still require a different analysis depending on the type of intercompany transaction being reviewed. And, the basic theory applied throughout the regulations is still 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.

There are a number of references to IRC §482 in the RTC. RTC §24725 conforms to IRC §482 and has been present in the RTC since 1951. The FTB has not adopted any regulations under RTC §24725. Therefore, the federal regulations pursuant to IRC §482 have applied for California purposes.[6] RTC §24725 was used infrequently. Further, for California purposes, the risk of improper intercompany transfers was minimized because of worldwide combined reporting, where intercompany transactions are generally eliminated.

RTC §25114 encompasses specific IRC §482 language and was enacted with the water's-edge provisions effective for income years beginning on or after January 1, 1988.[7] RTC §25114(b)(2) specifically states that the FTB must follow the federal rules and regulations pursuant to IRC §482 for income years beginning on or after January 1, 1988. With the event of the water's-edge legislation, the same IRC §482 issues facing the IRS are now an audit issue for California as well.

Realize that only the IRS or the FTB has the authority to raise an allocation issue pursuant to IRC §482. The taxpayer cannot compel the IRS or the FTB to pursue an IRC §482 issue.[8]

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 was enacted to allow the government to allocate or apportion income and deductions between entities owned or controlled by the same interests to clearly reflect income.[9] The Treasury has relied on IRC §482 to correct artificial intragroup pricing policies that are employed by taxpayers to achieve two primary goals:

1. 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
2. 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.[10]

IRC §482 is an amalgam of several important themes and policies of the tax law: tax-avoidance principles, the assignment of income doctrine, general deduction theories and clear reflection of income under the parties' accounting methods.[11] The purpose of IRC §482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer.[12] 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 1:

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 2:

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.

There is potential for the auditor to identify an IRC §482 issue anytime there is an intercompany transaction between entities that are not both included in the same combined report. Problems can arise from a wide variety of dealings between related corporations. IRC §482 can be applied to <u>any</u> intercompany transaction.[13] Such intercompany transactions could include:

1. Borrowing and lending money;
2. Renting or leasing of property;
3. Furnishing management or other services;
4. Transferring of income producing assets; or
5. Sharing facilities, properties and services.

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.

In addition, income may be shifted to entities to offset operating losses or to absorb expiring net operating loss carryovers. 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.

IRC §482 provides the FTB with the authority to reallocate income and deductions in order to remedy such problems. The statutory language is quite broad, indicating that 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's application of IRC §482. In general, the courts have sustained the IRS's IRC §482 adjustments unless the taxpayer has demonstrated that the IRS has been "...unreasonable, arbitrary or capricious."[14]

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.[15]

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.[16] Note the term "stock in trade" refers to the sale of inventory.

Example 3:

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 4:

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.

The fact that a transaction between controlled entities was made on other than an arm's length basis must be identified and proved by the auditor if an IRC §482 adjustment is to be sustained. The development of the facts and circumstances of intercompany transactions subject to IRC §482 is similar in some respects to the factual development needed to evaluate potential unitary relationships, but there is an added dimension to the IRC §482 audit. Not only must the auditor determine what transactions took place between the related entities, but he or she must apply the arm's length standard to them as well.

The IRS or FTB can compel each of the commonly controlled taxpayers to report the taxable income that would have resulted from dealing at arm's length with the 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.[17]

The taxpayer cannot, however, compel the IRS or the FTB to make or initiate an IRC §482 allocation. Although a taxpayer can reflect an allocation that satisfies §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.[18] Only the IRS or the FTB 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.

Realize that IRC §482 can involve corporations, partnerships, individuals, estates and trusts, domestic or foreign. This chapter has been prepared principally from the perspective of application of IRC §482 to multinational corporations. Virtually every key term and phrase of IRC §482 has been defined by the regulations or the courts. Each must be reviewed to gain an understanding of the scope, underlying principles and rules of application of the regulations pursuant to IRC §482.

d. Key Terms

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, discussed here, include:

1. Two or more organizations, trades or businesses;
2. Common ownership or control;
3. Distribute, apportion or allocate;
4. Evasion of taxes; and
5. Clear reflection of income.

1. Two Or More Organizations

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)."[19] The regulations emphasize the broadest interpretation possible of the terms organization, trade and business. The terms are broad enough to cover any type of taxable entity or enterprise which has independent significance for tax purposes.[20]

The term "organization" includes any organization of any kind. 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:

1. Place of organization, operation or conduct of the trade or business;
2. Whether the organization is domestic or foreign;
3. Whether or not the organization is exempt; and
4. Whether or not it is a member of an affiliated group that files a consolidated federal return.[21]

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.[22]

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."[23] The Revenue Act of 1934 amended IRC §45 to include organizations as well as trades or businesses. This language continued in the adoption of the 1954 and 1986 codes.[24] The amendment seems to eliminate any potential for this argument to be resurrected. Whether or not a holding company is a trade or business, it is certainly an organization and is not precluded from the application of IRC §482.

There have been disputes over whether or not an individual (or, perhaps, his or her activities) may be regarded as an organization, trade or business for purposes of applying IRC §482. This is a difficult area involving competing theories as to the scope and purpose of IRC §482, especially as it relates to assignment of income concepts. In several cases, shareholders have been held to be organizations, trades or businesses separate from corporations controlled by them or members of their family, so that income realized by the corporation could be reallocated to them under IRC §482.[25]

IRC §482 applies to transactions between a corporation and sole proprietorship operated by the corporation's controlling shareholder.[26] The proprietorship business is considered to be different from that of the corporation.[27] Also, a corporation and a partnership, which has the same corporation as a partner, have both been held to be "organizations" for purposes of IRC §482. The court noted that an organization should not "cease to be an 'organization' for purposes of IRC §482 merely because it is a partner in another organization."[28] Lastly, the IRS has ruled that IRC §482 may be applied to allocate income between brother-sister corporations, even if both are organized outside the United States.[29]

Questions about what constitutes an organization, trade or business under IRC §482 are quite rare. The statute, regulations and courts seem to have disposed of most of the areas of potential dispute.

2. Common Ownership Or Control

IRC §482 can only be invoked when entities are "...owned or controlled directly or indirectly by the same interests..."[30] Treasury Regulations (TR) §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. Determining control for these purposes is not based on a bright-line ownership test, but instead, is based on facts and circumstances. 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."[31] 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.[32]

A controlled taxpayer is any one of two or more taxpayers owned or controlled, directly or indirectly, by the same interests.[33] The definition of taxpayer was clarified in the regulations finalized in 1994 as any person, organization, trade or business, whether or not subject to any internal revenue tax.[34] Also added by these regulations, a controlled transaction or a controlled transfer means any transaction or transfer between two or more members of the same group of controlled taxpayers.[35] Group, controlled group and group of controlled taxpayers means the taxpayers owned or controlled, directly or indirectly, by the same interests[36]

IRC §482 applies to related corporations, whether or not the affiliated corporations qualify in the technical sense to file a consolidated return.[37] The regulations state that reality is decisive, not the form of the transaction. Thus, for purposes of IRC §482, control means effective control and is primarily concerned with economic realities. Therefore, substance over form takes precedence.[38]

A presumption of control does occur if income or deductions have been arbitrarily shifted.[39] When actual ownership by the same interests does not exist, but control does exist, the IRS must present evidence of income shifting before the presumption of correctness becomes operative.[40] However, it does not appear to be necessary to demonstrate that the persons with control expect to gain a direct economic benefit from exercising their power. It is enough that control has been exercised to distort the taxable income of the controlled entities.[41]

The courts have recognized that to find the existence of control a realistic approach must be applied. The tax court noted that the omission of specific ownership requirements in the regulations was intentional. This was to provide the IRS with flexibility. The court determined control by looking at such factors as who controlled the Board of Directors and the appearance of coordinated activities between the parties.[42]

It is common to see two unrelated corporations organize a jointly owned subsidiary. The purpose of the joint venture may be to share technology or to supply raw materials or services to the parent corporations at a price equal to or below the subsidiary's cost. The courts have held that IRC §482 can be applied in these situations because the parent corporations together are engaged in a business in creating the subsidiary, that this business is separate from the subsidiary's business, and that both businesses are under common control. Common control has been held to exist even though the parent corporations had no shareholders, directors or officers in common. The required control is present when two unrelated corporations each own 50 percent of the stock of a third corporation if the shareholders "act in concert" in their dealing with the jointly owned corporation in the pursuit of a "common interest or objective".[43] Further, the same rationale will also apply if the jointly owned entity is a partnership rather than a corporation.[44]

The obvious situation where control normally exists is the case where one corporation has clear legal voting control over the joint venture or partnership. Other situations where control may exist include:

1. Ownership of more than 50 percent of the equity (capital) interest and/or the profits interest, but not the voting interest, of the joint venture or partnership.
2. De facto or practical control over the joint venture or partnership. For example, where 40 percent of the joint venture is owned by one corporation and the other 51 percent is dispersed among many other shareholders, none of whom owns more than one percent.
3. Influence created by particular economic relationships rather than equity

ownership of the entity. For example, a case where a 50 percent equity owner provides all the debt financing to the joint venture and the other 50 percent equity owner provides none.

4. Actual decisive influence exerted by one entity over the other with respect to a specific transaction. For example, in a 50/50 joint venture, common control might be found between the joint venture and the venturer that supplies essential components with respect to an exclusive supply agreement for those components. The presence or absence of control would depend upon all the relevant facts and circumstances, including the degree of ownership and the significance and size of the particular transaction relative to the joint venture business.
5. Common economic interests of two parties with respect to a specific transaction, such that the two parties may be motivated to act in concert or with a common goal or purpose. The level of equity ownership or degree of influence required to create control would depend on all the relevant facts and circumstances. One might expect that the greater degree of influence, the lower the level of equity ownership necessary to find common control, and vice versa.[45]

When two corporations form a joint venture or partnership, they are acting in concert and with a common goal or purpose that is to produce a larger economic profit together then would be possible if the two corporations acted alone. The IRC §482 issue that is relevant is whether or not the joint activities include arbitrary shifting of taxable income on a non-arm's length basis.[46]

Because ownership is a convenient test, there is a tendency for auditors to look solely to ownership to determine whether control exists. However, flexibility was built into the statute in recognition that control can exist even when the control is not evidenced by actual ownership. In order to prevent form from taking precedence over substance, the auditor should keep in mind that it is sometimes necessary to look beyond the mere ownership percentages of the group.

3. Distribute, Apportion Or Allocate

IRC §482 states that "...the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances..." The authority given to the IRS by IRC §482 to distribute, apportion or allocate income had once been hotly debated. However, the issues that had been raised have since been resolved.

IRC §482 is designed to remedy only one abuse, "The shifting of income from one commonly controlled entity to another."[47] Presumably there would be no argument with this statement. The controversy surrounded how the income could be shifted, whether or not full realization of the transactions was necessary, and which transaction types would lead to a shifting of income.

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.[48]

Also, 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. It was argued that only income that had been realized could be allocated; income could not be created. However, because it would be administratively cumbersome to trace an intracompany transaction through the books of various corporations and for an unknown period of time, the courts did not require the realization of income before IRC §482 could be invoked.[49] Thus, for example, a cash basis taxpayer would be required to recognize arm's-length income allocated to it under §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 v. Comr*, (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..."

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.[50]

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 arose questioned the interplay of IRC §482 with nonrecognition provisions. Does IRC §482 override nonrecognition provisions such as IRC §351? This issue is discussed in Section 18.1(e), Water's-Edge Manual.

Another issue was 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[51] and Rooney v. United States.[52] 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.

Example 5:

A California corporation borrows money. It contributes the proceeds to a foreign, nonunitary subsidiary. The subsidiary uses the proceeds to acquire control of another corporation in a failed hostile takeover attempt. The subsidiary receives greenmail, which is not taxed in California. Can the interest expense attributed to the loan be allocated to the foreign subsidiary by the authority pursuant to RTC §24725?

An argument could be made for making an allocation if the state can show that the allocation of interest expense was necessary to clearly reflect income.

4. 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.[53]

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. 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.[54]

This is true even if income is shifted to a taxing jurisdiction having a higher tax rate.[55] Thus, for purposes of IRC §482, the auditor does not need to demonstrate intent by the taxpayer to defraud the government.

5. 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.[56]

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.[57] In Lucas the 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,[58] 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 than 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.[59] The issue of whether or not IRC §482 could be applied to effectively override nonrecognition provisions had been the subject of much controversy. For example, transfers of appreciated property to a controlled corporation, qualifying for gain nonrecognition under IRC §351, followed by the sale or other disposition of the property by the transferee could, unless challenged by the IRS, confer tax benefits not within the intent of the nonrecognition provisions.[60]

In National Securities Corporation v. Commissioner,[61] the court determined that IRC §45, the predecessor to IRC §482, was directed to correct situations in which strict application of other provisions would have resulted in the distortion of income. This case involved the transfer of a depreciated asset to a related corporation, who subsequently disposed of the asset and paid no tax on the gain from the sale. In its decision, the court analyzed whether or not there was a true business purpose for the transaction or if the underlying motive of the transaction was to give the taxpayer a tax benefit it would not have otherwise enjoyed. The court determined the application of IRC §45 to be appropriate.

In relation to the transfer of an income-producing intangible asset, it was not clear if the ruling in National Securities would apply when there was a valid business purpose for the transaction. By 1988 two cases were resolved that addressed this issue, Eli Lilly & Company v. Commissioner[62] and G.D. Searle & Company v. Commissioner.[63] According to the courts, a nonrecognition provision could not be disregarded just because a taxpayer used it to engage in the sort of activity that Congress had sought to encourage when it enacted the nonrecognition provision in the first place. But, this did not bar an allocation under IRC §482 to the extent necessary to prevent distortion.[64]

The regulations finalized in 1994 encompassed these court rulings. If IRC §351, or any other nonrecognition section, results in a distortion of income or avoidance of taxes, IRC §482 may be utilized to recast the sale, exchange or other transaction to properly reflect income or prevent the avoidance of taxes.[65]

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. Appropriate collateral adjustments include three adjustment classifications: correlative adjustments, conforming adjustments and set-off adjustments.[66] RTC §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.

For federal purposes, a correlative adjustment need not be made until one of the following events occurs with respect to the primary adjustment:

1. 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;
2. Acceptance of Form 870-AD, Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment;
3. Payment of the deficiency;
4. Stipulation in the Tax Court of the United States; or
5. Final determination of the tax liability by offer in compromise, closing agreement or court action.[67]

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:

1. Has a net operating loss, and the allocation increases or decreases such loss; or,
2. 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.[68]

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 or as a capital contribution. Or, pursuant to Revenue Procedure (Rev. Proc.) 65-17,[69] repayment of the allocated amount without further income tax consequences.[70] Thus, conforming adjustments are made applying the procedures specified in Rev. Proc. 65-17. (Rev. Proc. 65-17 was superceded by Rev. Proc. 99-32, effective generally for years beginning after August 23, 1999.) Rev. Procs. 65-17 and 99-32 are discussed in part 3 of Section 18.1(f), Water's-Edge Manual.

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. 65-17 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 income 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 listed below.

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.[71] For example, income may be re-characterized to increase or decrease earnings and profits. While this may not effect the immediate income year, this will subsequently effect 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. The taxpayer must:

1. 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;
2. Document all correlative adjustments resulting from the proposed set-off adjustment; and
3. 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.[72]

4. Statute Of Limitations

To provide the taxpayer proper notification, the IRS International Examiner (IE) will send a "pattern letter" to the taxpayer when the affiliated corporation is located in a treaty country. This is called a pattern letter because it contains "canned" paragraphs, which explain to the taxpayer that an IRC §482 issue will be pursued. The canned paragraphs must be included in all such letters. The letter also provides a list of the corporations that will be reviewed.

The Internal Revenue Manual requires that this pattern letter be given to the taxpayer when the auditor determines an IRC §482 issue exists between the taxpayer and its affiliated entity. The purpose of the pattern letter is to notify the taxpayer that an adjustment pursuant to IRC §482 will be pursued. It further recommends that the foreign affiliates request an extension of the statute of limitations for the foreign tax return. Then, it will be up to the foreign government to apply the collateral adjustments if it wishes.

It is not clear what happens if a correlative adjustment is needed and the statute of limitations has already expired. The regulations provide that the correlative adjustment is to be made for any *open* income year.[73] For conforming adjustments, the regulations state that the revenue procedures would be followed.[74] When the taxpayer is properly notified of the potential IRC §482 adjustment, it is the taxpayer's responsibility to protect the statute of limitations for the appropriate tax returns. There is a court case that allowed a correlative adjustment to be made even though the statute of limitations for filing a claim for refund on the part of the other members had expired.[75] The adjustment was allowed even though the taxpayer had apparently not been properly notified when the IRS initiated the IRC §482 audit.

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 RP 65-17, 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 RP 65-17 is generally the only option for the taxpayer. Alternatively, the taxpayer may attempt to negoiate 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. Realize, however, Competent Authority only exists for those foreign countries with which the United States has a tax treaty.

Lastly, Competent Authority can apply any law or any settlement procedure it chooses to resolve the disputed issue.

3. Revenue Procedure 65-17

Prior to August 23, 1999, Rev. Proc. 65-17 set forth the procedures to be followed in cases where a United States taxpayer requested permission to receive payment from another entity. The procedure applied to United States taxpayers whose income has been increased for an income year by reason of an IRC §482 allocation. Such a taxpayer may request permission to receive payment from the entity from, or to, which the allocation of income or deductions was made. The amount requested may be equal to all or a portion of the amount allocated. Rev. Proc. 65-17 has been superceded by Rev. Proc. 99-32. Although Rev. Proc. 65-17 will still be followed for older years, Rev. Proc. 99-32 will become effective for taxable years beginning after August 23, 1999 (Taxpayers may elect to apply the provisions of Rev. Proc. 99-32 to taxable years that include August 23, 1999).

Rev. Proc. 65-17 permits tax-free treatment of amounts paid or repatriated after the fact so that cash flows will correspond with the finalized tax treatment of the related party transactions.[76] For example, if a §482 allocation shifts income from a subsidiary to its parent, the subsidiary will have to remit a payment to its parent to conform its accounts to the §482 outcome. Normally, the payment would be treated as a dividend payment and would trigger its own tax consequences. However, under Rev. Proc. 65-17, an account receivable is deemed to be established as of the last day of the year of the §482 allocation. In the year that the payment is made, it is treated as a tax-free satisfaction of that receivable. The account receivable must bear interest at an arm's length rate. The establishment of a receivable is also permitted under Rev. Proc. 99-32.

If a dividend or capital contribution was received from the related party, that amount may be recharacterized as a prepayment of the account receivable. Under Rev. Proc. 65-17, this treatment is available for dividends received from the related party during the year of the §482 allocation. If the dividend is applied to the account receivable, it is no longer treated as a dividend for any other purpose. (e.g., it is no longer taxed as dividend income, and no longer eligible for dividend received deductions.) The dividend offset was limited by Rev. Proc. 99-32. Under the new Rev. Proc., if the §482 adjustment was the result of an IRS audit, the dividend offset is only available for dividends, capital contributions or other offsets that occurred during the taxable year when the closing agreement was entered into.

It was unclear whether Rev. Proc. 65-17 treatment would be available for taxpayer-initiated adjustments made pursuant to Treas. Reg. §1.482-1(a)(3). Rev. Proc. 99-32 contains clarification regarding how the procedures will apply to such taxpayer-initiated adjustments, and also states that taxpayers will be permitted to apply a reasonable interpretation of Rev. Proc. 65-17 to taxpayer-initiated adjustments for years prior to the effective date of Rev. Proc. 99-32.

If the taxpayer requests and is allowed to use procedures from Rev. Proc. 65-17 or 99-32, it must enter into a closing agreement with the IRS disclosing the receivable amount, the interest accrued and the income year. Payment on the account receivable must be made within 90 days after the execution of the closing agreement. In the absence of such agreements, arguably any subsequent repatriations by the party whose income was decreased by the IRC §482 adjustment would be considered a dividend distribution and taxable by the domestic shareholder.

To qualify for Rev. Proc. 65-17 treatment, tax avoidance must not have been one of the principal purposes of the primary transaction. Under Rev. Proc. 99-32, the criteria is changed so that a taxpayer will not qualify if it is subject to a penalty under IRC §6662(e)(1)(B) or (h) (regarding the substantial valuation misstatement provision of the accuracy-related penalty). This changes the focus of the inquiry from the facts and circumstances nature of "tax avoidance" to the adequacy of the taxpayer's documentation in support of their pricing method.

There are a substantial number of procedural requirements to be met before Rev. Proc. 65-17 or 99-32 treatment will be granted. See the Revenue Procedures themselves for more information regarding these procedures.

Rev.Proc. 65-17 was amplified by Rev. Proc. 65-31,[77] amended and clarified by Rev. Proc. 70-23,[78] and further amplified and clarified by Rev. Proc. 71-35.[79] As explained above, it was prospectively superceded by Rev. Proc. 99-32 as of August 23, 1999.

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 or §446(b) apply, there is no mandatory collateral adjustment to be made and the taxpayer has no relief available under Rev. Proc. 65-17. The lack of Rev. Proc. 65-17 relief may be very costly where payments in question are made by a domestic corporation to a foreign shareholder because the payments would be characterized as dividend income to the extent they are disallowed as excessive. The result would be the imposition of the withholding tax pursuant to IRC §871/§881 and IRC §1441/§1442. When Rev. Proc. 65-17 relief is allowed, the repayment of any amount is allowed without tax consequences. Both the income tax and the withholding tax liabilities are withdrawn.[80]

IRC §936 contains provisions that relate to transactions between United States corporations and affiliated possessions corporations. Possessions corporations were discussed in detail in Chapter 7, Water's-Edge Manual and are also discussed in Section 18.7, Water's-Edge Manual.

Lastly, IRC §367 governs transfers of corporate assets to foreign affiliates. IRC §367 is discussed in detail in Chapter 19, Water's-Edge Manual.

i. Effective Dates

The temporary regulations issued in 1993 were effective for income years beginning after April 21, 1993, but have been superseded to the extent that the final regulations apply. The final regulations are effective for all taxpayers for income years beginning after October 6, 1994.[81] For any open income year beginning after April 21, 1993, and before October 5, 1994, the taxpayer has the choice of applying either the temporary regulations or the finalized regulations. The effective dates are discussed in more detail in Section 18.5, Water's-Edge Manual.

j. 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. RTC §25114(a) requires that the FTB examine every return for potential IRC §482 noncompliance. If noncompliance with respect to the arm's length standard exists, a detailed examination must be performed. This is regardless of the potential net revenue to the state. The FTB must perform the audit unless the IRS is addressing the same issue for the same income year. The FTB must follow the federal regulations, rules and procedures to address this issue.[82]

RTC §25114(b)(3) states that if the IRS has conducted a detailed audit, the FTB must follow the results of the IRS examination unless the FTB demonstrates that the IRS audit results are clearly erroneous. The presumption of correctness would apply to any accepted Advanced Pricing Agreement (APA) or any adjustment made by the IRS Appeals Division, the IRS Legal Division or IRS Competent Authority. Thus, any applicable APA or Competent Authority adjustment would be made for state purposes unless the adjustment is clearly erroneous. 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's failure to pursue the issue nor can a presumption be made that the transactions were correctly reported.

There are a number of sources to review to better understand IRC §482. In particular, this chapter of the Water's-Edge Manual should be read. The regulations pursuant to IRC §482 contain several examples that are not included in this chapter of the Water's-Edge Manual. The regulation applicable to your particular type of intercompany issue should be read. 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., <u>Westreco, Inc., v. Commissioner</u>,[83] <u>Perkin-Elmer Corporation v. Commissioner</u>,[84] <u>Seagate Technology, Inc., v. Commissioner</u>,[85] <u>National Semiconductor Corporation v. Commissioner,</u>[86] <u>Compaq Computer Corp. v. Commissioner</u>,[87] <u>DHL Corp. v. Commissioner</u>.[88]

2. Evaluating Whether §482 Noncompliance Exists

Initially, your primary objective should be to collect enough information to evaluate the intercompany transactions of the taxpayer. Because of the statutory requirement that every water's-edge return be examined for §482 noncompliance, every water's-edge case is required to have a separate program item with an analysis of this issue. The analysis should evaluate the level of potential pricing noncompliance and contain the auditor's recommendation as to how to proceed with the issue.

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:

1. No or minimal intercompany transactions between the foreign and domestic groups;
2. Transfer prices appear reasonable based on the analysis conducted by the auditor, encompassing comparisons to industry standards;
3. The potential pricing issue is immaterial; or
4. The IRS is auditing the pricing issues for the same income years.

Auditors are encouraged to contact the International Specialist as needed for additional guidance regarding whether the facts of a particular case indicate a potentially material pricing issue.

Should the auditor determine that there is a potentially material pricing issue, the recommendation whether to pursue a §482 audit should be forwarded to the auditor's 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. The Pricing Audit Review Committee will meet as needed to discuss all transfer pricing audit recommendations received, and make the final decision as to whether resources should be allocated to conduct a particular pricing audit. If approval for the audit is granted, then the auditor can continue pursuing the required information. Specialists, an economist, an industry expert and/or an attorney will be assigned to the case as needed.

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. Usually, when an IRS IE is assigned to a case to assist the IRS Revenue Agent the IE will send the taxpayer a pattern letter, discussed in part 4 of Section 18.1(f), Water's-Edge Manual. The IE will issue IDRs separate and apart from the IDRs of the Revenue Agent. Also, at the conclusion of the IE's audit involvement, the IE will typically write a final report detailing the taxpayer's business activity, what international issues were reviewed and all conclusions made by the IE for the audit cycle.

Written evidence of the IE's involvement should be obtained. The presence of an IE and copies of the pricing IDRs is one example of adequate documentation that the IRS is examining a taxpayer for pricing issues. The IDRs will typically identify the entities being reviewed and the income 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. A copy of the pattern letter, a written statement from the IE or a copy of other correspondence from the IE to the taxpayer can also be acceptable. Again, the IE can be contacted if clarification is needed as to what the IE is reviewing. Realize that the IE may audit other international issues (e.g., FSC, subpart F income, etc.,) and not address pricing. Further, the IRS may not pursue a pricing issue because of workload constraints or because of foreign tax credit implications.

The auditor must use judgement when the IRS audit cycle is different from the income years being audited for state purposes. If the IE is auditing pricing issues for the income years prior to our audit cycle and if the taxpayer is normally audited by the IRS, then concluding that the IRS will address the California audit cycle for pricing issues may be appropriate. If the IRS has skipped income years, the auditor will need to determine why this is the case to decide whether or not the pricing issue needs to be addressed for state purposes.

In most instances, the auditor can assume when the IRS commences a pricing audit that the IRS is auditing all of the taxpayer's pricing issues. This assumption can be overcome in limited situations and is obviously not valid if the taxpayer has an electing possessions corporation using the IRC §936(h) profit-split method. The IRS does not conduct transfer pricing examinations of possessions corporations electing the profit-split method. Since California does not conform to IRC §936(h), a pricing issue would potentially exist for which California would not have IRS coverage.

Should the 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. Audit considerations are discussed in Section 18.2, Water's-Edge Manual, Section 18.3, Water's-Edge Manual, Section 18.3, Water's-Edge Manual and Section 18.8, Water's-Edge Manual.

Under the regulations, comparability must be evaluated by using a list of factors, including the:

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

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.[89] To make a proper determination, the auditor 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 pages of regulations and a history of court cases. This continues to be one of the most controversial code sections.

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. In the following sections specific transactions as well as examination techniques will be discussed.

The next section is *Loans and Advances*, Section 18.2, which discusses IRC §482 and TR §1.482-2(a) which apply to intercompany loans and advances between related parties.

Footnotes

1. Treasury Regulations (TR) §1.482-1(b)(1).
2. Internal Revenue Code (IRC) of 1954, §482.
3. Public Law (PL) 99-514, Tax Reform Act of 1986, dated October 22, 1986, 1986-3 Cumulative Bulletin (CB), page 1.
4. Understanding the New U.S. Transfer Pricing Rules, by Deloris Wright of Coopers & Lybrand, 1993, page 18.
5. Revenue Notice 88-123, 1988-2 CB, page 458.
6. California Code of Regulations (CCR) §26422.
7. Senate Bill 85, Stats. 1988, Chapter 989.
8. TR §1.482-1(a)(3).
9. TR §1.482-1(a)(1) and (2).
10. Fundamentals of International Taxation, US Taxation of Foreign Income and Foreign Taxpayers, by Boris I. Bittker and Lawrence Lokken, Second Edition 1991, 15.03.1, page 15-16.
11. Federal Income Taxation of Corporations And Shareholders, by Boris I. Bittker and James S. Eustice, Fifth Edition 1987, updated by 1993 Cumulative Supplement No. 2, May 1993, 15.03.1, page 15-15.
12. TR §1.482-1(a)(1). Your Host, Inc., v. Commissioner, 58 TC 10, 24 (1972), aff'd 489 F2d 957 (2nd Circuit 1973), cert. denied, 419 US 829 (1974). First Security Bank of Utah, 405 US 394 (1972).
13. TR §1.482-1(f)(1). TR §1.482-1(i)(7).
14. Richard D. Foster v. Commissioner, 80 TC 34, 140-142 (1983), aff'd without discussion of this issue, 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 (N.D. Ala. 1967). Grenada Industries, Inc., v. Commissioner, 17 TC 231 (1951), aff'd 202 F2d 873 (5th Circuit 1953), cert. denied, 346 US 819 (1953).
15. Bush Hog Manufacturing Company, Inc., v. Commissioner, 52 TC 601 (1964), acq'd, 165-2 CB.
16. Ibid., note #13.
17. TR §1.482-1(a)(1). Ibid., note #10, 79.1, page 79-2.
18. Ibid., note #8.
19. IRC §482.
20. TR §1.482-1(i)(2).
21. TR §1.482-1(i)(1).
22. Ibid., note #19.
23. Asiatic Petroleum Company v. Commissioner, 79 F2d 234 (2nd Circuit

1935), cert. Denied, 296 US 645 (1935).
24. IRC of 1954, §482. IRC of 1986, §482.
25. Dolese v. Commissioner, 811 F2d 543 (10th Circuit 1987). Richard Rubin v. Commissioner, 460 F2d 1216 (2nd Circuit 1972).
26. Ach v. Commissioner, 42 TC 114 (1964), aff'd 358 F2d 342 (6th Circuit), cert. denied, 385 US 899 (1966). Borge v. Commissioner, 405 F2d 673 (2nd Circuit 1968), cert. Denied sub nom., Danica Enterprises, Inc., v. Commissioner, 395 US 933 (1969).
27. Ibid., note #11, 15.03.2, page 15-17.
28. Revenue Act of 1928, §45. Revenue Act of 1934, §45. IRC of 1954, §482. IRC of 1986, §482.
29. Aladdin Industries, Inc., v. Commissioner, 41 TCM 1515 (1981).
30. Ibid., note #8.
31. TR §1.482-1(i)(4).
32. Charles Town, Inc., v. Commissioner, 25 TCM 77 (1966), aff'd 372 F2d 415 (4th Circuit 1967), cert. denied, 389 US 841 (1967).Grenada Industries, Inc., v. Commissioner, 17 TC 231 (1951), aff'd 202 F2d 873 (5th Circuit 1953), cert. denied, 346 US 819 (1953).
33. TR §1.482-1(i)(5).
34. TR §1.482-1(i)(3).
35. TR §1.482-1(i)(8).
36. TR §1.482-1(i)(6).
37. Ibid., note #11, 15.03.2, page 15-19.
38. TR §1.482-1(i)(4).
39. Ibid., note #37.
40. Ibid., note #17, page A-5. Brittingham v. Commissioner, 66 TC 373 (1976), aff'd 598 F2d 1375 (5th Circuit 1979).
41. Ibid., note #11, 15.03.3, page 15-19.
42. Cayuga Service, Inc., v. Commissioner, 34 TCM 18 (1975).
43. B. Foreman Company v. Commissioner, 54 TC 912 (1970), rev'd, 453 F2d 1144 (2nd Circuit 1972), cert. Denied, 407 US 934 (1972), reh'g denied, 409 US 899 (1972).
44. Private Letter Ruling 8045071, dated August 15, 1980.
45. Transfer Pricing: Alternative Practical Strategies, Tax Management Foreign Income Portfolios (BNA) No. 890, by Marc M. Levey, Esq., page A-307.
46. Ibid., note #44.
47. Your Host, Inc., v. Commissioner, 58 TC 10, 24 (1972), aff'd 489 F2d 957 (2nd Circuit 1973), cert. denied, 419 US 829 (1974).

48. Hospital Corporation of America v. Commissioner, 81 TC 520 (1983), non-acq'd in part, 1987-2 CB, page 1.
49. 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.)
50. TR §1.482-1(f)(1)(ii).
51. Central Cuba Sugar Company v. Commissioner, 198 F2d 214 (2nd Circuit 1952), cert. denied, 344 US 874 (1952).
52. Rooney v. United States, 305 F2d 681 (9th Circuit 1962).
53. Asiatic Petroleum Company v. Commissioner, 99 F2d 234 (2nd Circuit 1935), aff'd 31 BTA 1152, cert. Denied, 296 US 645 (1935).
54. TR §1.482-1(f)(1) and (f)(1)(i).
55. Ibid., note #17, page A-10.
56. TR §1.482-1(i)(9).
57. Lucas v. Earl, 281 US 111 (1930).
58. Rubin v. Commissioner, 51 TC 251 (1968), 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).
59. TR §1.482-1(f)(1)(iii).
60. Section 482 Allocations, Tax Management Portfolios (BNA) No. 230-3rd, by Harrison B. McCawley, Esq., page A-3.
61. National Securities Corporation v. Commissioner, 137 F2d 600 (3rd Circuit 1943), cert. denied, 320 US 794 (1943).
62. Eli Lilly & Company v. Commissioner, 84 TC 996 (1985), aff'd in part, rev'd in part, and rem'd 856 F2d 855 (7th Circuit 1988).
63. G.D. Searle & Company v. Commissioner, 88 TC 252 (1987), amended March 3, 1987.
64. Ibid., note #61 and note #62.
65. Ibid., note #59.
66. TR §1.482-1(g)(1).
67. TR §1.482-1(g)(2)(iii).
68. TR §1.482-1(g)(2)(ii). International Issues, Phase I, Module I, by IRS, Training No. 3135-217, dated November 1993, page I-1-13.
69. Revenue Procedure (RP) 65-17, 1965-1 CB, page 833.
70. TR §1.482-1(g)(3).
71. TR §1.482-1(g)(4)(i).
72. TR §1.482-1(g)(4)(ii).
73. TR §1.482-1(g)(2)(ii).
74. TR §1.482-1(g)(3)(i).

75. Collins Electrical Company, Inc., v. Commissioner, 67 TC 911 (1975). Although the court allowed the §482 adjustment, it expressly noted that it did not intend its holding to be read to sanction a double tax on the same income (a tax as a result of the primary adjustment without an accompanying correlative adjustment).

    The court noted that barring a primary adjustment where the statute of limitations is closed for the correlative adjustment would open the door for a related taxpayer to block the primary adjustment by simply failing or refusing to file a claim for refund. On the other hand, if the related taxpayer is required to file a claim for refund, the IRS could effectively tax the same income to both taxpayers through careful timing of issuing the notice of deficiency on the primary adjustment. (The court noted that the IRS notified both parties of the need to file a claim, demonstrating that the IRS did not attempt to take an unfair advantage of the taxpayer. However, the court thought the right to a correlative adjustment cannot depend on which side is to blame for procedural errors).

    The court commented that §482 may contemplate a suspension of the running of the statute of limitations on claims for refund of the overpayment attributable to the correlative or may impose a duty on the IRS to refund the overpayment without regard to the statute of limitations. The court did not attempt to answer this question, however, because the taxpayer due the refund arising from the correlative adjustment was not before the court.
76. RP 65-17, 1965-1 CB, page 833.
77. RP 65-31, 1965-2 CB, page 1,024.
78. RP 70-23, 1970-2 CB, page 505.
79. RP 71-35, 1971-2 CB, page 573.
80. Revenue Ruling 82-80, 1982-1 CB, page 89.
81. TR §1.482-1(j)(2).
82. Revenue and Taxation Code §25114(b).
83. Westreco, Inc., v. Commissioner, 64 TCM 849 (1992).
84. Perkin-Elmer Corporation v. Commissioner, 66 TCM 634 (1993).
85. Seagate Technology, Inc., v. Commissioner, 102 TC No. 9 (February 8, 1994).
86. National Semiconductor Corporation v. Commissioner, 67 TCM 2849, 2872 (May 2, 1994).
87. Compaq Computer Corp. v. Commissioner, TCM 1999-220, 7/2/99

88. DHL Corp. v. Commissioner, TCM 1998-461, 12/30/98
89. *International Issues*, Phase I, Module I, by IRS, Training No. 3135-217, dated November 1993, page I-1-15.

Section 18.2 Intercompany Transfer Pricing Loans And Advances

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References:

Revenue and Taxation Code §24725
Revenue and Taxation Code §25114

California Code of Regulations §25114
Internal Revenue Code §482
Treasury Regulations §1.482-1
Treasury Regulations §1.482-2(a)

Training Objectives:

This section of the chapter will discuss the specific application of Internal Revenue Code (IRC) §482 to loans or advances between related parties. At the end of §18.2, you will have a basic understanding of Treasury Regulation (TR) §1.482-2(a), including the determination of when interest is required, the applicable time period for which interest must be charged, the appropriate arm's length interest rate to apply, and the proper amount of interest to allocate pursuant to IRC §482.

a. Introduction

Section 18.1, Water's-Edge Manual discussed the general concepts of IRC §482. This section will specifically address the application of IRC §482 to loans and advance payments made between related corporations. TR §1.482-2(a) specifically applies to the borrowing and lending of money between related corporations. The rules related to loans and advances were not changed by the 1993 temporary regulations or the 1994 finalized regulations. The rules remain within TR §1.482-2(a) and continue to apply.

This section is primarily focused on intercompany loans and advances between the water's-edge group and its foreign affiliates. However, realize that the issue can also arise between a combined report group and non-unitary affiliates or divisions that are excluded from the combined report. When intercompany accounts are analyzed, the auditor should also consider the intercompany loans and advances made to excluded affiliates to determine whether or not the issue should be pursued.

In general, application of TR §1.482-2(a) to loans and advances tends to be the easiest of the IRC §482 issues. Further, the assistance and analysis of an economist is generally not required.

b. In General

1. Interest On Indebtedness

The authority allowed by TR §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. This includes:

1) Loans or advances of money, or other consideration, whether or not there is a written instrument;[1] and
2) 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.[2]

TR §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.[3] 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.[4]

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.[5] TR §1.482-2(a) applies to both in-bound and out-bound indebtedness.

Example 1:

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.

Example 2:

USCO borrows $10 million from its Swiss subsidiary, Time, at a 20 percent interest rate, compounded monthly. The market interest rate for a similar loan type would have been 10 percent, compounded monthly. An IRC §482 allocation would be necessary to decrease USCO's interest expense applying the appropriate market terms to USCO's loan.

TR §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.[6] However, several courts have upheld the application of TR §1.482-2(a). Thus, this argument has been resolved,[7] except for the following situation:

In Pitchford's, Inc., v. Commissioner,[8] 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 (IRS) 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. In the case of bona fide indebtedness between related parties, excluding contributions of capital and distributions with respect to its stock, IRC §482 may be applied by the IRS to allocate an arm's length rate of interest if the actual arrangement bears no interest rate or carries an interest rate that is below an arm's length rate.[9] Payments made with respect to alleged indebtedness shall be treated according to their substance. 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 TR §1.482-2(a).[10]

This regulation is intended to allocate interest with respect to bona fide indebtedness only. Therefore, if the transaction is actually a contribution to capital, a corporate distribution, a lease or a service transaction, no allocation for interest may be made under this section. Payments made with respect to alleged indebtedness shall be treated according to the substance of the transaction.[11]

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, TR §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 on discussed in Section 18.2(e), Water's-Edge Manual.[12]

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.[13]

Unless providing loan guarantees is an integral part of the corporation's business, the appropriate intercompany charge is the corporation's out of pocket costs, which are generally not significant. Regardless, loan guarantees fall under the scope of Section 18.3, Water's-Edge Manual.

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.[14] 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.[15] Another example would be the application of the original issue discount (OID) rules to foreign currency loans. Proposed TR §1.1274-6(c) uses a foreign currency rate similar to the Applicable Federal Rate (AFR), which is discussed in part 3 of Section 18.2(d), Water's-Edge Manual.

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.[16] If the lender is regularly engaged in the trade or business of making loans to unrelated parties, the factors used in determining a true arm's length interest rate must consider to the interest rates charged by the lender to unrelated parties on loans or advances of a similar type within the same approximate time period as the loan or advance made to the related party.[17]

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.[18]

Example 3:

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.[19]

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 TR §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.[20] When determining which AFR to apply, the loan period is considered including any options to renew or to extend the loan period.

For loans or advances with a stated interest rate transacted before July 1, 1981, the safe haven interest rate range is 6 to 8 percent, simple interest. A simple 7 percent interest rate applies for loans and advances with no stated interest rate that is transacted before July 1, 1981.[21]

For loans and advances with a stated interest rate transacted after June 30, 1981, and before May 9, 1986, the safe haven interest rate range is 11 to 13 percent, simple interest. A simple 12 percent interest rate applies for loans and advances with no stated interest rate that is transacted after June 30, 1981, and before May 9, 1986. The regulations provided a grandfather clause for certain loans existing in 1986.[22] The grandfather clause provides that loans and advances made before May 9, 1986, or made before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986, remain subject to the 11 to 13 percent interest rate range.

For loans and advances with a stated interest rate made after May 9, 1986, which do not qualify for the grandfather clause, the safe haven interest rate is based on the AFR. 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, which do not qualify for the grandfather clause, 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.[23] 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.[24]

Thus, loans payable in foreign currency do not qualify for the safe harbor interest rates, nor do loans by professional lenders.[25]

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.[26] 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.[27]

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). The federal tax services (e.g., CCH and Prentice-Hall) publish cumulative tables of the AFRs for the current and prior months. 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 4:

Assume that the stated interest rate on a loan, transacted in March 1993, is 10.25 percent, compounded annually. The original repayment term was two years, three months. Based on the March 1993 loan date, assume the AFR for that month is obtained and the following analysis is performed:

	Period for Compounding Annual
AFR	8.68%
130%	11.28%

Note that the 130% line is determined by multiplying 8.68% by 130% and 8.5% by 130%.

Solution: Because the stated interest rate of 10.25 percent is between 8.68 percent (100% of the AFR) and 11.28 percent (130% of the AFR), no adjustment is warranted.

Effective April 1, 1988, TR §1.482-2(a) was revised to conform to other IRC sections, including those enacted or amended by the Tax Reform Act of 1984, which related to the computation of interest applying the AFR.

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.[28] 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.[29] For this computation refer to TR §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 Section 18.2(f), Water's-Edge Manual.

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.[30]

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.[31]

With respect to intercompany trade receivables arising before July 1, 1988, the interest-free period on which interest is not required to be charged is six months or longer, if regular industry practice allowed a period longer than six months.

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.[32]

For intercompany trade receivables arising after June 30, 1988, TR §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:

1. Certain intercompany transactions in the *ordinary* course of business (the debtor member's business is conducted within the United States);[33]
2. Transactions carried on in a trade or business conducted outside the United States by the debtor member;[34]
3. A trade or business where the creditor member's industry, as a regular practice, allows unrelated parties a longer payment period without charging interest;[35] and
4. Property purchased for resale in a foreign country.[36]

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.[37] 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 to determine whether a particular trade receivable was paid within the applicable interest-free period.[38]

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.[39]

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.[40]

Example 5:

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 6:

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 7:

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.[41]

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.[42]

Example 8:

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.

Example 9:

On April 1, an Italian corporation buys 120 leather jackets from USCO, a related affiliate, for which a trade receivable is established. USCO receives the full balance due on the following September 23. Interest must be accrued on this trade receivable from August 1 through September 23.

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.[43]

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 10:

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:[44]

1. 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[45]
2. Ten calendar days.[46]

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. 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 TR §1.954-3(a)(4) and is discussed in Chapter 9, Water's-Edge Manual.[47] 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 11:

Brazilian Ltd., mines, cuts and polishes gems in Brazil then sells the gems to its related United States subsidiary. For purposes of TR §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.

For any loan or advance arising prior to June 30, 1988, the regulations in effect for this type of intercompany trade receivable provided for an interest-free period of six months, after which the required interest was computed based on an average monthly balance. For additional guidance for this calculation, review the applicable regulation.

B. AVERAGE COLLECTION PERIOD

There are four computational steps needed to determine the average collection period. The average collection period is determined by first calculating the total sales by the related purchaser within each product group to unrelated persons located in the same foreign country during the related purchaser's last income year ending on or before the first day of the related seller's income year in which the intercompany trade receivable arose.[48]

A product group is defined as all products within the same three-digit Standard Industrial Classification, or the SIC code.[49] If the related purchaser makes sales in more than one product group in any foreign country, or makes sales in more than one foreign country, a separate computation of the average collection period, by product group, within each country is required.[50]

The income year to be tested is the related purchaser's (debtor's) last income year ending on or before the first day of the related seller's income year in which the intercompany trade receivable arose. For example, if the purchaser acquires goods from the related selling member and both the buyer and seller have calendar year-ends, for goods purchased during the entire 1995 income year, the test period to determine the applicable interest-free period would be the 1994 income year.

For the second step, the related purchaser's average month-end trade receivables balance, with respect to sales determined in step one above, for the test period must be determined.[51] Note that a FIFO rule is generally applied to payments to determine the month-end receivable balances. See the discussion of the FIFO rule in Part of 1 of Section 18.2(e), Water's-Edge Manual.

For step three, the trade receivables turnover rate must be computed by dividing the total sales amount determined in step one by the average trade receivables balance determined in step two.[52] For the last step, 365 days is divided by the trade receivables turnover rate determined in step three. The result is rounded to the nearest whole number. This result is the number of days in the average collection period.[53]

If the intercompany trade receivables arise from the resale by the related purchaser of fungible property in more than one foreign country, and the intercompany trade receivables arising from the related party purchase of such fungible property cannot be reasonably identified with the resales in a particular foreign country, then for purposes of making the computation of the average collection period a pro rata portion of each account receivable may be allocated to a particular foreign country based on the ratio of the resales made in that foreign country to total resales of the fungible property to all foreign countries.[54]

C. AVERAGE COLLECTION PERIOD EXAMPLE

Example 12:

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 1994.

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

MONTH - 1993	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:

Note that because the interest-free period is being determined for 1994, 1993 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	$ 14,400 $ 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 1994 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

Before IRC §482 would be applicable, a number of other code sections dealing explicitly with imputed interest must be taken into account, including IRC §163(j), excess related party interest expense; IRC §467, certain rental agreements; IRC §483, imputed interest on deferred payments attributable to the sale or exchange of property; IRC §1274, original issue discount on certain debt instruments issued for property (OID rules); and IRC §7872, certain loans with no interest or below-market interest rates. In many cases, these code sections will take precedence and the application of IRC §482 will not be needed.[55]

TR §1.482-2(a)(3) provides the order in which the different code sections take precedence. First, 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 will apply. After evaluating the true substance of the transaction, any remaining bona fide debt will be applied to IRC §482 or the other code sections. The most applicable section, IRC §467, IRC §483, IRC §1272 or IRC §7872, is to be applied first. Finally, IRC §482 may then be applied as needed.

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. IRC §483 and IRC §1274 impute interest where debt instruments are issued for consideration for the sale or exchange of "untraded" property. An IRC §483 adjustment may convert part of the sales price on the sale of the property to interest. Where the property is untraded and such instrument fails to provide adequate interest, within the meaning of IRC §1274, or interest that is considered excessive, within the meaning of proposed TR §1.1274-1(d), amounts payable under the instrument characterized by the parties as payments of principal and interest may be recharacterized to interest.[56]

Where a debt instrument is issued by one member of a controlled group to another as consideration for the purchase of property, proposed TR §1.1012-2 can be applied to recharacterize the transaction as a sale in part and a transfer of property, e.g., a contribution or distribution, depending on the relationship of the parties, in part.[57]

IRC §7872 imputes interest with respect to certain loans bearing "below market" interest. IRC §7872 may overshadow much, if not all, of any IRC §482 adjustment in the low-interest rate loan area since the imputed interest rate is the same and IRC §7872 takes priority.[58] IRC §7872 is a very broad section and conceivably could apply to situations exempted by IRC §482, such as the interest-free period granted to intercompany trade receivables. Temporary regulations were issued July 9, 1986, which exempts indebtedness under IRC §7872 if the indebtedness is also exempt from application of IRC §482, but only during the interest-free period.[59]

Example 13:

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.

Example 14:

Assume the same facts as Example 13, except that the amount lent to Birch from Ash is $9,000. Under the $10,000 de minimis exception of IRC §7872(c)(3), no adjustment for interest will be made under IRC §7872. Thus, IRC §482 is now applied to determine whether or not the rate of interest on the loan is at arm's length.

In summary, once the true substance of a transaction is determined, the other code sections will 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, the code and regulations of the applicable sections should be reviewed.

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 the proposed regulations for IRC §483 and §7872.[60] 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,[61] on a month-end outstanding balances,[62] and on a average month-end balance.[63]

Based on these court cases and recent changes to the AFR, the IRS training manual states that the proper method of computing interest on unpaid trade receivables is to compute interest based on the actual monthly balances because the applicable interest rate changes monthly with the short-term AFR. The manual further states that the other methods discussed above are acceptable based on facts and circumstances.[64]

2. Initial Considerations

Remember, before you can apply IRC §482 to any loan or advance, you must first determine whether or not other sections apply to the transaction. The first step is to identify what transaction you have, then to apply the first applicable IRC section before you apply IRC §482. IRC §482 and the other applicable sections have similar goals and ask for similar information.

1) Is there a deferred payment, loan or obligation for which interest must be computed?

This is the first question you must address.

2) Should interest accrue on the deferred payment, loan or obligation?

For this you need to know about any exceptions, or interest-free periods allowed by the applicable code section. For example, IRC §7872 excepts from its rules, certain intercompany trade receivables during the interest-free period allowed by IRC §482.

3) What is the correct amount of interest?

This is a two step question. First you must determine what interest, if any, the taxpayer did accrue on the obligation. Then, you must compare that interest with the amount of interest that should have been accrued. You can also compare the interest rate stated on the obligation with the test rates or safe haven rates provided by the applicable code section. The difference between the interest accrued by the taxpayer and the adjusted amount of interest is the potential adjustment.

4) What is the correct tax treatment of the interest?

64. *International Issues*, Phase I, Module I, by IRS, Training No. 3135-217, dated November 1993, page I-2-23 and page I-2-32.

If you are auditing the creditor (seller), the interest will usually be considered ordinary income. Depending on the code section, the interest will be reportable either in the year of the transaction which gave rise to the interest or it must be amortized over a stated period. For example, if interest should be accrued for each year a loan balance is outstanding, you need to be concerned that an appropriate amount of interest was accrued for the year under examination for the balance outstanding.

IRC §482 is the only section which requires a correlative adjustment to be made for the other side of the transaction. For example, if you adjust for interest income under IRC §482, you must allow interest expense to the debtor.

3. 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, the regulations for IRC §483 provide tables with a required discount factor depending on the contract date. Tables VII through IX provide the applicable factors for contracts entered into after July 1, 1981, and presumably through December 31, 1984. 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 will 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.

Proposed TR §1.1274-5 provides basic formulas for determining present value, depending on the number of payments, single or a stream of payments, and the term, periods per year and short periods for less than a full year. A few examples follow here. However, for those of you who have not seen this computation in a while, a present value table or a present value function on a calculator or on Excel (fx button-function wizard) can be used. Refer to the regulations for more examples of the present value calculations.

(1) Single Payment With No Short Period:

Example 15:

Assume that a single payment of $1,000,000 is due 2 years and 9 months from the computation date. Further, assume that a monthly compounding period is selected and that the discount rate based on a monthly compounding period is 9 percent. Because the payment is due in 2 years and 9 months, and the compounding period is one month, the payment is due on a date that is 33 whole compounding periods from the computation date. The present value of the payment is $781,471.58.

(2) Single Payment With a Short Period:

There are two formulas used to compute interest for a short period, the exact method and the approximate method. The exact method has a specific formula to apply. The approximate method is provided for convenience. This method assumes simple interest within any compounding period and always produces an amount of interest for the short period that is slightly higher than the amount of interest produced under the exact method.

Example 16:

A $200,000 interest-free demand loan is outstanding on January 1 and repaid on March 31. Assume that the AFR, based on semiannual compounding, for demand loans is 10 percent. The amount of interest that would have been payable on the loan for the year if the loan provided for interest at the AFR determined under the approximate method is $5,000.

3) Stream of Payments With No Short Period, Payment at the End of Each Full Compounding Period:

Example 17:

Assume that on January 1, 1986, a payment schedule calls for payments of $10,000 due at the end of each of the next five years. The first payment is due January 1, 1987, and subsequent payments due on January 1 of each subsequent year until January 1, 1991. The compounding period is one year. Assume that the discount rate of interest based on an annual compounding period is 12 percent. Because the payment schedule calls for payments due at the end of full compounding periods, the schedule consists of a stream of payments which continues for five full compounding periods. The present value of the stream of payments is $36,047.76.

4. IRC §482 Interest - Calculation Shell

The following shell applies to the calculation of allocable interest to intercompany trade receivables for the first three types described in Section 18.2(e), Water's-Edge Manual: United States intercompany transactions, foreign intercompany transactions and regular industry practice.

Table 1:

INTERCOMPANY TRADE RECEIVABLES						
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
Month	Balance Beginning of Month	(+)Monthly Charges	(-)Monthly Payments or Charges	Ending Balance of the Month	(-) Last Months Sales *	Monthly Balance
January						
February						
…						
December						

*Note for column 5, the sales subtracted is dependent on the type of the intercompany trade receivable. For example, if these are United States trade receivables, the last three months of sales are removed. Thus, either three or four months of sales are removed from the balance. Or, the applicable industry number of months of sales is removed, whichever applies.

Table 2:

IRS §482 INTEREST - MONTHLY CALCULATION	
Monthly Total From Table 1, Column (6)	$ _______________
Monthly Short-Term AFR	_____%
IRS§482 Monthly Interest	$ _______________
Reported Monthly Interest	($_____________)
IRC §482 Adjustment for the Month	$ _______________

5. Conclusion

Included in this section are just some of the examples from the regulations of which you should become familiar. Once it is determined which IRC section applies to the loan or advance transaction, the additional examples in the regulations of the various code sections should be reviewed.

h. Audit Considerations

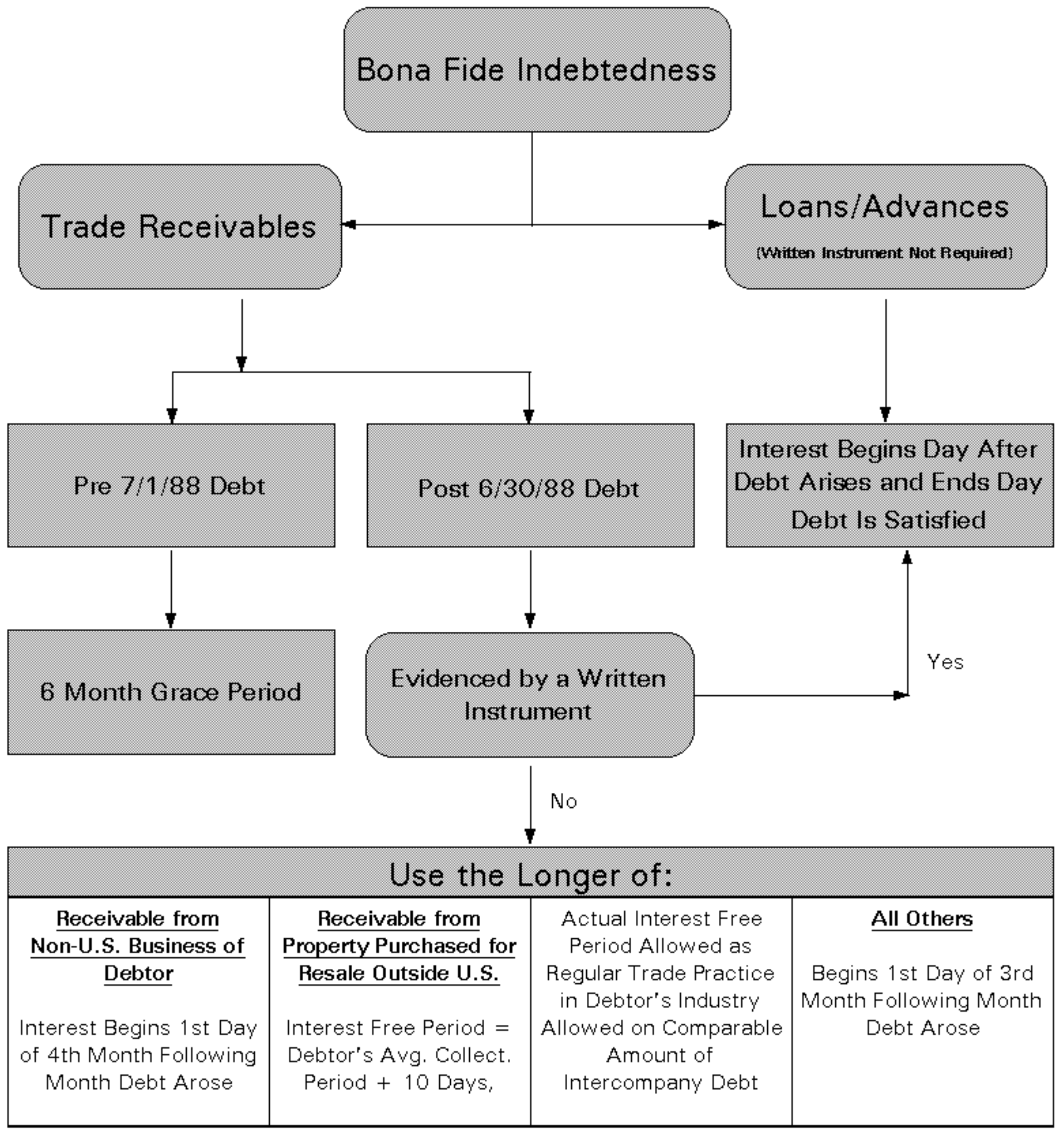
1. Obtain organizational charts to determine ownership of all domestic and foreign companies.
2. Analyze Board of Directors minutes and Executive Committee minutes, if applicable, for discussions of loans or advances with related entities, particularly with controlled foreign corporations.
3. Analyze the federal Forms 1120, federal Forms 1120F, SEC Form 10-k filings, Annual Reports and intercompany audit reports. Review the accounts receivable and accounts payable, loans to shareholders and other related persons, and investments in subsidiaries to both identify loans or advances or to find significant fluctuations in the account balances.
4. Analyze the federal Forms 5471 and 5472. Pay particular attention to the following:
   a. Income Statement - Are there any deductions for interest expense? Is there interest income? Compare these items with prior and subsequent years to search for increases which potentially arise from new intercompany loans.
   b. Balance Sheet - Review beginning and ending balances of the accounts receivable, accounts payable and other liabilities for significant changes. Review loan amounts from shareholders and other related persons.
5. Review the footnotes to the domestic and foreign financial statements for the discussion of loans or advances between related entities.
6. Request applicable loan agreements. Compare the terms of the agreement with the actual interest paid or interest received by the related entities.
7. For intercompany trade receivables, request an aging analysis to determine whether the corporation is properly charging interest. From the aging, the length of the repayment period can be determined. If repayment occurs within 60-90 days, a problem probably does not exist. If repayment takes longer, a problem may exist.
8. For intercompany trade receivables or payables, determine:
   a. Whether all or only a portion of the balance qualifies for an interest-free period. Remember only intercompany trade receivables arising in the ordinary course of business, which are not evidenced by a written instrument, qualify for the interest-free periods.

b. When interest amounts have been charged to intercompany trade receivables, ensure payments were applied on a FIFO basis. Under the general rule, all amounts arising in a particular month are treated as a single block of trade receivables, and the payment for each block is due by the end of the second month following the month in which the receivables arise, or the third month if the debtor is involved in a foreign trade or business. Thus, by comparing total charges and credits for a month, you should be able to determine that the taxpayer has complied with the regulations.

c. When interest amount has been charged to intercompany trade receivables, ensure the interest rate applied was within the safe haven interest rate range. Or, ensure the interest rate was arm's length.

9. Consider other applicable code sections prior to applying IRC §482.[65]

Application of IRC §482



i. Summary

1. TR §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. TR §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 TR §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 TR §1.482-2(a) by using the safe haven interest rates. The taxpayer can also overcome an allocation pursuant to TR §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.For intercompany trade receivables arising before June 30, 1988, the interest-free period is six months, unless the taxpayer could apply the trade practice exception. For those receivables arising after June 30, 1988, 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.

This section discussed the application of IRC §482 and TR §1.482-2(b) to intercompany loans and advances. The next section, §18.3, *Services*, will discuss the application of IRC §482 and TR §1.482-2(b) to services performance for or on the behalf of a related party.

Footnotes

1. Treasury Regulation (TR) §1.482-2(a)(1)(ii)(A)(1).
2. TR §1.482-2(a)(1)(ii)(A)(2).
3. TR §1.482-2(a)(1).
4. Transfer Pricing: The Code and The Regulations, Tax Management Foreign Income Portfolios (BNA) No. 887, by John P. Warner, Esq., page A-32.
5. Ibid., note #3.
6. Fitzgerald Motor Company v. Commissioner, 60 T.C. 957, rev'd 75-1 USTC 9522.
7. 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, 34 TCM 368 (1975).
8. Pitchford's, Inc., v. Commissioner, 34 TCM 384 (1975).
9. Federal Income Taxation of Corporations And Shareholders, by Boris I. Bittker and James S. Eustice, Fifth Edition 1987, updated by 1993 Cumulative Supplement No. 2, May 1993, 15.03.6, page 15-24.
10. TR §1.482-2(a)(1)(ii)(B).
11. Ibid., note #10.
12. TR §1.482-2(a)(1)(iii)(A).
13. Private Letter Ruling (PLR) 7822005. PLR 77-12289960A.
14. TR §1.482-2(a)(2)(iii)(D) and (E).
15. TR §1.7872-11(f).
16. TR §1.482-2(a)(2)(i).
17. TR §1.482-2(a)(2)(iii)(D).
18. TR §1.482-2(a)(2)(ii).
19. Revenue Ruling 74-566.
20. TR §1.482-2(a)(2)(iii)(C).
21. TR §1.482-2(a)(2)(iii).
22. TR §1.482-2(a)(2)(iii)(A)(2).
23. TR §1.482-2(a)(2)(iii)(D).
24. TR §1.482-2(a)(2)(iii)(E).
25. Ibid., note #9.
26. TR §1.482-2(a)(2)(iii)(B)(3).
27. TR §1.482-2(a)(2)(iii)(C)(3).
28. Transfer Pricing: The Code and The Regulations, Tax Management Foreign Income Portfolios (BNA) No. 887, by John P. Warner, Esq., page A-32.

29. Ibid., note #27.
30. Ibid., note #12.
31. TR §1.482-2(a)(1)(iii)(A).
32. TR §1.482-2(a)(1)(iii)(E)(4)(iv).
33. TR §1.482-2(a)(1)(iii)(B).
34. TR §1.482-2(a)(1)(iii)(C).
35. TR §1.482-2(a)(1)(iii)(D).
36. TR §1.482-2(a)(1)(iii)(E).
37. Ibid., note #31.
38. TR §1.482-2(a)(1)(iii)(E)(4)(iv)(A).
39. TR §1.482-2(a)(1)(iii)(E)(4)(iv)(B).
40. Ibid., note #33.
41. Ibid., note #28, page A-31.
42. Ibid., note #34.
43. Ibid., note #35.
44. TR §1.482-2(a)(1)(iii)(E)(1).
45. TR §1.482-2(a)(1)(iii)(E)(1)(i).
46. TR §1.482-2(a)(1)(iii)(E)(1)(ii).
47. TR §1.482-2(a)(1)(iii)(E)(2).
48. TR §1.482-2(a)(1)(iii)(E)(3)(i).
49. Ibid., note #47.
50. TR §1.482-2(a)(1)(iii)(E)(3)(v).
51. TR §1.482-2(a)(1)(iii)(E)(3)(ii).
52. TR §1.482-2(a)(1)(iii)(E)(3)(iii).
53. TR §1.482-2(a)(1)(iii)(E)(3)(iv).
54. Ibid., note #50.
55. Ibid., note #9.
56. Ibid., note #28, page A-30.
57. Ibid., note #56.
58. Proposed TR §1.7872-1(a)(2)(iii).
59. TR §1.7872-5T(b)(12).
60. Proposed TR §1.483-2, TR §1.482-4, TR §1.7872-12, TR §1.7872-13 and TR §1.274-3.
61. Collins Electric Company v. Commissioner, 69 TC 911 (1977).
62. Kahler Corporation v. Commissioner, 486 F2d 1 (8th Circuit 1973), 73-2 USTC 9687, rev'd and rem'd 58 TC 496 (1972).
63. Fitzgerald Motor Company v. Commissioner, 508 F2d 1096 (5th Circuit 1975), 75-1 USTC 9275 rev'd 60 TC 957.
64. *International Issues*, Phase I, Module I, by IRS, Training No. 3135-217,

dated November 1993, page I-2-23 and page I-2-32.

65. Ibid., note #64, page I-2-14 and page I-2-43.

Section 18.3 Intercompany Transfer Pricing Services

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References:

Revenue and Taxation Code §24725
Revenue and Taxation Code §25114
California Code of Regulations §25114
Internal Revenue Code §482
Treasury Regulations §1.482-1
Treasury Regulations §1.482-2(b)

Training Objectives:

This section of the chapter will discuss the specific application of Internal Revenue Code (IRC) §482 to the performance of services for or on the behalf of a related party. At the end of §18.3, you will have a basic understanding of Treasury Regulations (TR) §1.482-2(b), including the benefit test, the appropriate arm's length charge dependent on whether or not the activity is an integral part of the taxpayer's business activity, and items to consider when auditing the performance of intercompany services.

a. Introduction

Section 18.1, Water's-Edge Manual discussed the general concepts of IRC §482 while Section 18.2, Water's-Edge Manual discussed the application of TR §1.482-2(a) to loans and advances between related parties. This section will specifically address the second type of transaction contemplated by TR §1.482-2, which is the performance of managerial, technical or other services for or on the behalf of a related party.

The rules related to the intercompany performance of services have not changed with the 1993 temporary regulations nor the 1994 finalized regulations. The rules remain within TR §1.482-2(b) and have essentially been the same since 1968, with the exception of minor re-numbering within the regulation subsections. Thus, the same rules, related to the intercompany performance of services, continue to apply.

In general, application of TR §1.482-2(b) to intercompany services may be an easier IRC §482 issue because the arm's length charge is based on actual costs incurred. Further, in many cases, the assistance and analysis of an economist is not needed.

b. In General

When one member of a controlled group performs services for the benefit of, or on behalf of, another member of the controlled group at no charge, or at a charge which is not an arm's length amount, an allocation may be made to reflect an arm's length charge for such services.[1] The term "services" is broadly defined to include any kind of service, such as marketing, managerial, administrative, technical or any other type.

TR §1.482-2(b) deals with situations where one member of a controlled group performs services for another member and there is either no charge at all, or an undercharge. Allocations may also be made in situations where an excess charge has been made. This situation is encountered quite frequently. If a United States corporation pays excessive commissions to a controlled foreign corporation (CFC), then effectively the shifting of income occurs.[2] 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 attack 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, Revenue and Taxation Code (RTC) §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.[3] 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 Chapter 9, Water's-Edge Manual.

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. For example, TR §1.954-4(b)(2)(ii)(b), requires that the cost of performing services be determined after taking into account any adjustments under IRC §482.

c. Benefit Test

For a transaction to fall within the scope of the IRC §482 regulations, services must have been performed with the intention of benefiting one member or jointly benefiting several members of a controlled group. This is the benefit test. The intention will be considered to have existed if there was a reasonable expectation that a benefit would result to the other group member.[4] Allocations may be made if the services, at the time they were performed, related to the carrying on of an activity by another member or was intended to benefit another member, either in the member's overall operations or in its day-to-day operations.[5]

Example 1:

Amaco Corporation and Bidwell Corporation are members of a controlled group. Amaco's international division engages in a wide range of sales promotion activities. Most of the activities are undertaken exclusively for the benefit of Amaco's international operations. However, some are intended for the joint benefit of Amaco and Bidwell and some are exclusively for Bidwell's benefit. An allocation may be made to reflect an arm's length charge for the activities undertaken for the joint benefit of Amaco and Bidwell consistent with the relative benefits intended as well as for those services performed exclusively for the benefit of Bidwell.[6]

Example 2:

Airway, Ltd., operates an international airline. Pleasant Corporation is a related company, which owns and operates hotels in several cities serviced by Airway. In conjunction with its advertising of the airline, Airway often pictures Pleasant's hotels and mentions Pleasant's name. Although the advertising was intended to primarily benefit Airway's airline operations, some of the benefits would accrue to Pleasant. Since an unrelated hotel operation would have been charged for this advertising an allocation would be in order to reflect an arm's length charge consistent with the benefits intended.[7]

The allocation must be consistent with the relative benefits intended and must be made even if the benefits anticipated from the services are not realized. Thus, the application of IRC §482 is based on the benefits expected when the services are rendered and the allocation is not nullified by the taxpayer demonstrating that the expected benefits were not realized.[8]

Example 3:

Oversight Corporation's foreign subsidiary, Marker, Ltd., engages Oversight to review its method of handling the flow of raw materials and supplies in its manufacturing activity with the objective of cutting its manufacturing costs. After an extensive analysis, Oversight's personnel make some recommendations for changes. However, the recommendations do not cut costs to Marker's expectations. Although Marker did not derive the benefits it intended from the services, an allocation should be made to reflect an arm's length charge consistent with the benefits intended.

Meeting the benefit test is an important first step. An allocation cannot be made pursuant to IRC §482 without meeting this test. The regulations preclude an allocation when the probable benefits to the other member of the group are so indirect or remote that unrelated parties would not have charged for the services.[9]

Example 4:

Airway Corporation and Relax-Here Corporation are members of the same controlled group. Airway operates an international airline and Relax-Here owns and operates hotels in several cities serviced by Airway. In its advertising, Airway neither mentions nor inserts pictures of Relax-Here's hotels. Although it is reasonable to assume that Relax Here would benefit from the increased air travel, such a benefit would be indirect and remote. Since an unrelated party would not have been charged for such services, no allocation is made.[10]

Example 5:

USCO, Ltd., sends a team to review the operations as well as the effectiveness of the management of its foreign subsidiary. The team was instructed to present its findings before the Board of Directors of USCO. The services performed were not for the benefit of the foreign subsidiary. Therefore, an allocation pursuant to IRC §482 would be precluded.

Also, the regulations preclude an allocation pursuant to IRC §482 when the service is merely a duplication of a activity which the related party has independently performed or is performing for itself.[11]

Example 6:

Glossy Corporation and Charts Ltd., are members of the same controlled group. Charts, Glossy's subsidiary, develops formats for an advertising campaign. Before implementing the campaign, Charts asks Glossy to have its staff review the formats. Glossy's staff does so and sanctions them without making any material changes. Because Charts has independently performed the services, no allocation would be made.

Example 7:

Money Corporation and Investing Corporation are members of a controlled group. At the request of Investing, the financing staff of Money makes an analysis to determine the amount of the borrowing needs of Investing. Investing does not have personnel qualified to make the analysis. Investing does not perform the same analysis. An allocation pursuant to IRC §482 to reflect an arm's length charge is appropriate.[12]

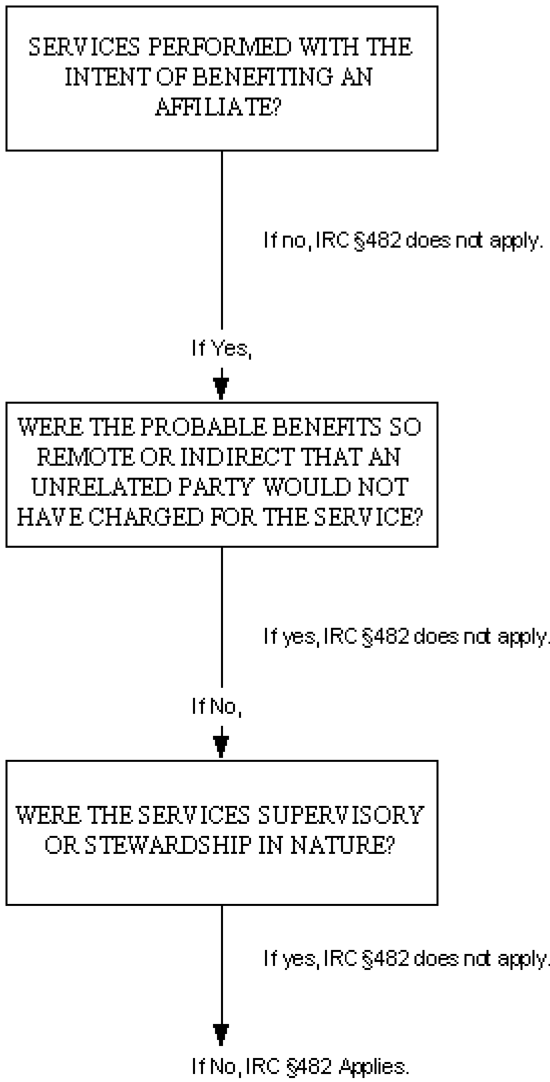
In setting down the benefit rule, the regulations offer no criteria to determine in all situations whether a service was performed for the benefit for another party. When analyzing the data, distinction must be drawn between supervisory services and those services which directly benefit the other related party. This is because the authority to make an allocation pursuant to §482 does not extend to activities representing the exercise of supervisory control over a company or group of companies by the controlling entity. A service is supervisory in nature if incurred for the benefit of the entity performing the service.[13]

The two leading cases concerning stewardship or supervisory services are Columbian Rope Company v. Commissioner[14] and Young and Rubicam, Inc., v. United States.[15] The courts did not uphold allocations pursuant to IRC §482 where:

i) The subsidiaries were fully staffed;
ii) The executive's visits were occasional and for relatively short time periods; and
iii) There was no participation in the day-to-day business operations.[16]

Many domestic corporations pay and deduct a portion of the salaries of the United States personnel sent abroad to work for the related foreign subsidiaries. In such cases, a review must be performed to determine what functions are being performed by such personnel and who receives the benefit, the parent or the foreign subsidiary. If the parent primarily benefits and the activity is supportive in nature, no allocation can be made.

PERFORMANCE OF SERVICES - THE BENEFIT TEST



Example 8:

USCO has a staff of financial analysts who evaluate the corporation's borrowing needs and conclude that $1,000,000 should be borrowed. This recommendation is forwarded to USCO's parent corporation whose financial analysts review the recommendation and acquiesce to the plan to borrow. No charge for the parent's review may be imputed pursuant to IRC §482 because the review duplicates the original analysis and is performed by the parent as part of its overseeing activities, not for the purpose of benefitting the subsidiary.

d. Arm's Length Charge

1. In General

The arm's length charge for services rendered is the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts.[17]

2. Services Are Not An Integral Part Of Business Activity

When the services performed do not constitute an integral part of the business, the regulations allow the arm's length charge to be the cost of performing the services without a profit mark-up. The rationale for this is that it is common for a parent corporation to assist one or more of its subsidiaries with management and administrative tasks. It is also common for the sharing of costs within a controlled group for services performed by one or more group members. Thus, to require a profit mark-up, in addition to the costs incurred, would contravene business practices that have been in effect for years. Further, these established business practices were not driven by tax avoidance motivations.[18]

Unless the services performed constitute an "integral part" of the business of either party, the arm's length charge is deemed to be equal to the service provider's costs or deductions incurred with respect to the services rendered. The service provider's costs are deemed to be arm's length unless the taxpayer establishes a more appropriate charge.[19] Both direct and indirect costs associated with the services provided must be considered in determining the arm's length charge.[20]

It is necessary to take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the services provided.[21] The direct costs are those identified specifically with a particular service, and indirect costs consist of other costs that relate to the direct costs.

Direct costs or deductions are those specifically identified with a particular service. These include, but are not limited to:

1. Costs or deductions for compensation, bonuses and travel expenses attributable to employees directly engaged in performing such services;
2. Materials and supplies directly consumed in rendering such services; and
3. Other costs, such as the cost of overseas cables, in connection with such services.[22]

Indirect costs or deductions are those which are not specifically identified with a particular activity or service. However, these indirect costs must relate to the direct costs specifically identified with such service. Indirect costs or deductions generally include costs or deductions with respect to utilities, occupancy, supervisory and clerical compensation, and other overhead burden of the department incurring the direct costs or deductions. Indirect costs or deductions also generally include an appropriate share of the costs or deductions relating to supporting departments and other applicable general and administrative expenses to the extent reasonably allocated to a particular service or activity.[23]

Example 10:

Barn Cuff Corporation's advertising department performs advertising services for the benefit of its foreign subsidiary. The services Barn Cuff provides are not an integral part of Barn Cuff's business. Thus, the fee charged by Barn Cuff should equal direct and indirect costs incurred by Barn Cuff's advertising department.

The direct costs include the employee salaries and the fees paid to an advertising consultant. In addition to these direct costs, the indirect costs incurred include the advertising department's overhead share of depreciation, rent, property taxes, any other cost of occupancy and any other reasonable overhead allocation of the advertising department's costs. It also includes the allocation of costs from other departments, such as the personnel, accounting, and maintenance departments, and other applicable general and administrative expenses, including compensation of top management.[24]

The direct and indirect costs or deductions of the service renderer, specifically excludes three items:

1. Interest expense on indebtedness not incurred specifically for the benefit of another member of the group; i.e., interest expense other than interest on funds borrowed specifically for the benefit of the recipient of the services;
2. Expenses associated with the issuance of stock and maintenance of shareholder relations; and
3. Expenses of compliance with regulations or policies imposed upon the member rendering the services by its government which are not directly related to the service in question.[25]

The regulations provide some flexibility for allocating and apportioning indirect costs to a service charge. If the members actual method of allocating and apportioning costs to its subsidiaries is reasonable and in keeping with sound accounting practice, that method will not be disturbed.[26]

In establishing the method of allocation and apportionment, appropriate consideration must be given to all bases and factors, including, for example, total expenses, asset size, sales, manufacturing expenses, payroll, space utilized and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other department's costs by means of application of reasonable departmental overhead rates.[27] Regardless, the taxpayer should allocate indirect expenses to both operating divisions as well as profit centers.[28]

The costs incurred by supporting departments may be apportioned on any reasonable basis (e.g., overhead rate estimates, sales, property, payroll, etc.). The allocation, however, must be based on full costs as opposed to incremental costs. For example, a machine rented by the taxpayer is used for the joint benefit of itself and the other group members. The service charge must be based on the full rent and operating cost of the machine, even if the additional use of the machine for the benefit of the others, did not increase the cost to the taxpayer.[29] This rule was criticized while the regulations were in proposed form. In reply, a Treasury official pointed out that the taxpayer can always establish a more appropriate charge.[30]

The regulations specify that when the costs and deductions are a factor in applying TR §1.482-2(b) adequate books and records must be maintained by the taxpayer to permit verification of such costs or deductions.[31] In general, the Internal Revenue Service (IRS) accepts the taxpayer's allocation of costs if the allocation is reasonable and in keeping with sound accounting practices.[32] The taxpayer's allocations have added weight if they are also used in preparing the financial statements for external reporting purposes or used within analyses for internal management reporting purposes, e.g., the shareholders, creditors, joint venturers, clients, customers or potential investors. Also, the IRS is more likely to accept the taxpayer's allocations between domestic and foreign members of the group if the same methods are used in allocating costs among domestic members of the group.[33]

Example 9:

For purposes of reporting to its public stockholders, Keller Barns, Inc., apportions its costs attributable to the executive officers among the domestic group members on a reasonable and consistent basis. These same officers also exercise comparable control over the foreign members of the controlled group. Thus, applying the domestic apportionment practice in determining the foreign group members' allocations will be acceptable for purposes of IRC §482.[34]

3. Services Are An Integral Part Of Business Activity

When services performed constitute an integral part of either the service renderer's or the service recipient's trade or business, the service fee to be charged must be a true arm's length charge.[35] Thus, direct and indirect costs are not automatically deemed to be the arm's length charge. Where the service is an integral part of the business or trade, the true arm's length charge is that amount that would have been charged for similar services in independent, unrelated transactions. Accordingly, the arm's length charge would typically include direct costs, indirect costs and a profit mark-up.

e. Integral Part Of Business Activity Defined

1. In General

TR §1.482-2(b)(7) describes situations where services rendered are considered an integral part of the business activity of a controlled group. In these situations, it is considered appropriate to require that the renderer of the service include a profit mark-up in the service fee charged. The regulations identify four situations when services are considered to be an integral part of an entity's business activities. These four situations include:

1. Either the entity performing the services or the service recipient is engaged in the trade or business of rendering similar services to unrelated parties.[36]
2. The entity performing the services performs the services for one or more related party and the services rendered are one of its *principal activities*.[37]
3. The service provider is *peculiarly capable* of rendering the services and the services rendered are a *principal element* in the operations of the recipient.[38]
4. The recipient has received the benefit of *substantial services* from one or more group members during the income year.[39]

2. Engaged In Such Trade Or Business

This first situation is straight forward. If either the corporation performing the services for a related party or the service recipient is engaged in a trade or business that performs similar services to unrelated parties, then the services are an integral part of its business activity.

Example 11:

Petry, Ltd., is in the business of providing engineering services to unrelated parties. Petry also performs such services for two related parties, Bridges Corporation and Highway, Ltd. Since Petry performs similar services for unrelated parties, the services performed for Bridges and Highway are considered to be an integral part of Petry's business.[40]

Example 12:

Papel, Ltd., performs marketing and advertising services for its subsidiary, Wellsly Corporation. Wellsly is in the business of rendering such services to unrelated parties. Since Wellsly, the recipient of the services, is in the business of rendering marketing and advertising services to unrelated parties, the services performed by Papel for Wellsly are an integral part of Papel's business.[41]

Example 13:

Artistico Corporation is engaged in the business of designing, printing and mailing advertising material for unrelated parties. Artistico also prepares brochures that advertise the products of Make It, Inc., a manufacturing enterprise wholly owned by Artistico's sole shareholder. Because the services performed by Make It are similar to services performed by Artistico for unrelated parties in the ordinary course of its business, the services are an integral part of Artistico's business. Thus, the charge to Make It for the services provided by Artistico must be a true arm's length price, not a price based only on costs.[42]

Thus, if the service renderer or the service recipient is engaged in a trade or business performing similar services for unrelated parties, then the services performed are considered to be an integral part of the service renderer's business activity and a true arm's length charge must be used for the intercompany service fee charged a related party.

3. Principal Activity

The performance of services for related parties is *presumed* not to be a principal activity if the costs incurred in performing the services for the income year do not exceed 25 percent of the service renderer's total costs or deductions for the income year. If the corporation performs services for related parties which constitute manufacturing, production, extraction or construction activity, then this 25-percent test cannot be applied.[43]

For purposes of applying the 25-percent test, all costs, both direct and indirect, of providing the services are taken into account, including the costs of any services provided to unrelated parties which constitute a manufacturing, production, extraction or construction activity. Total costs or deductions of the service renderer for the income year will exclude the cost of goods sold. Further, all amounts considered for the 25-percent test must be amounts properly based on arm's length standards. If this is not the case, the 25-percent presumptive test will not apply.[44]

Example 14:

Peepers Corporation and Optical Corporation are members of the same controlled group. Peepers manufacturers eye glasses for distribution and sale in the United States, Canada and Mexico. Optical manufactures eye glasses for distribution and sale in Europe. Optical requests assistance from Peepers to correct defects in its manufacturing equipment. In response, Peepers sends a team of engineers to detect and correct the defects. Does the 25-percent principal activity test apply to the services Peepers performs?

Yes. Although the services performed by the engineers are related to a manufacturing activity, the services are essentially support activities in nature and would not constitute a manufacturing, production, extraction or construction activity. Thus, the 25-percent test applies to determine whether the services provided by Peepers are a principal activity.[45]

Example 15:

Assume Apple, Inc., Beta Company, Cedar, Ltd., and Dogwood Corporation are members of the same controlled group. Dogwood renders wrecking services to Apple, Beta and Cedar. In addition, Cedar sells building materials and supplies to unrelated parties. The corporations file separate tax returns. The costs or deductions incurred by Dogwood for the income year, excluding its cost of goods sold, are $4,000,000. The total costs or deductions directly and indirectly related to the services rendered to Apple, Beta and Cedar are $650,000.

Because $650,000 is less than 25 percent of Dogwood's total costs or deductions ($650,000/$4,000,000=16.25%), the services rendered by Dogwood to Apple, Beta and Cedar will not be considered to be one of Dogwood's principal activities. Thus, the services are not an integral part of Dogwood's business and an allocation pursuant to IRC §482 would be based on the deemed arm's length charge of costs or deductions incurred in performing the services. No profit mark-up is required.[46]

Thus, whether the services provided to a group member are considered a principal activity of the renderer, depends first on the 25-percent presumptive test. The presumption is made that services are not a principal activity if the costs are less than 25 percent of the total costs or deductions of the renderer for the income year. If the costs exceed 25 percent or if the 25-percent test does not apply because the entity is manufacturing, then whether such services are a principal activity is driven by the facts and circumstances. The relevant facts and circumstances include the:

1. Time devoted to the rendition of the services;
2. Cost of the services;
3. Regularity with which the services are rendered;
4. Amount of capital investment;

5. Risk of loss involved; and
6. Whether the services are in the nature of supporting services or independent of the other activities of the renderer.[47]

Example 16:

In connection with the construction of a plant for Joyco Corporation, its foreign subsidiary located in New Finland, Sutton, Inc., draws the architectural plans for the plant, arranges the financing of the construction, negotiates with various government authorities in New Finland, and accepts bids from unrelated parties for several phases of the construction. On Joyco's behalf, Sutton also negotiates the contracts with the unrelated parties who are hired to carry out certain phases of the construction. The unrelated companies retained by Sutton perform the actual physical construction. Does the 25-percent principal activity test apply to determine if the services rendered by Sutton are its principal activity?

No. Although Sutton does not actually perform the construction, the aggregate services performed by Sutton for Joyco are such that they, in themselves, constitute a construction activity. Thus, the 25-percent test cannot be applied. Accordingly, the facts and circumstances must be reviewed to determine if the services are a principal activity.[48]

Example 17:

Pop Top Corporation, due to a breakdown in machinery, is forced to cease operations for one month. During this period, Pop Top sends partially completed goods to a related corporation, Top 'Em, Ltd., who completes the product and ships it back to Pop Top. Top 'Em's costs related to the manufacturing services to Pop Top are $750,000. Top 'Em's total costs for the income year are $24,000,000.

Because the services of Top 'Em constitute a manufacturing activity, the 25-percent test will not apply. Instead, the facts and circumstances must be reviewed to determine whether this is a principal activity. Because the services rendered to Pop Top in relation to Top 'Em's total operations are inconsequential, 3% ($750,000/$24,000,000=3%); the services are rendered over a short time period (one month); and because of the lack of regularity in performing these services (a one time event); Top 'Em's services to Pop Top are not a principal activity of Top 'Em. Thus, the services are not an integral part of Top 'Em's business and an allocation pursuant to IRC §482 would be based on the deemed arm's length charge of costs or deductions incurred in performing the services, or $750,000.[49]

Example 18:

Assume the same facts as in Example 14 above, except that: the costs or deductions directly and indirectly related to the services rendered by Dogwood to Apple, Beta and Cedar are $1,800,000; there is a high risk involved in rendering the services; Dogwood has a large investment in the wrecking equipment; and Dogwood devotes substantial time to rendering the wrecking services to Apple, Beta and Cedar. Does the activity constitute a principal activity to Dogwood?

Because $1,800,000 is greater than 25 percent of Dogwood's total costs or deductions ($1,800,000/$4,000,000=45%), the services will not automatically be excluded from the classification of a principal activity. Thus, determination of whether or not the activity is a principal activity will be based on the facts and circumstances. Because of the high risk, a large capital investment and the substantial time involved, the wrecking services to Apple, Beat and Cedar constitute one of Dogwood's principal activities. Thus, the services are an integral part of Dogwood's business and an allocation pursuant to IRC §482 would be based on the true arm's length charge of performing the wrecking services.[50]

For purposes of the 25-percent presumptive test, at the option of the taxpayer, a consolidated group can elect to be considered the renderer where one or more members of the consolidated group render services for or on the behalf of a related party that is not a member of the consolidated group. Thus, the consolidated group may elect to apply their aggregate costs, excluding costs between consolidated members, with respect to the services performed.

For purposes of this election, the term "consolidated group" means all members of a group of controlled entities created or organized within a single country and subjected to an income tax by such country on the basis of their combined income.[51] Thus, in applying the 25-percent test, all entities organized under the laws of a particular country may be treated as a single service renderer if their income tax liability in that country is determined on a consolidated basis.[52]

Example 19:

Rex Corporation, a United States corporation, and its United States subsidiaries file a consolidated return for United States tax purposes. Rex and its United States subsidiaries may be treated as one entity in applying the 25-percent principal activity test to services performed by the United States members of the group for foreign subsidiaries.[53]

This consolidation election enables domestic corporations, whose principal or only activity is to perform services for foreign related parties, to remain below the 25-percent threshold by including the costs or deductions of the other domestic corporations included in the consolidated group.

Example 20:

Fortress, Inc., (parent) and Steller Company (subsidiary) file a consolidated tax return. Fortress and Steller may elect to be treated as the renderer for purposes of the 25-percent test. Steller's sole activity is to provide accounting, billing, communications and travel services to Fortress' foreign subsidiaries at a total cost of $710,000, Steller's total operating expenses. Fortress also renders some other services to these same affiliates at a cost of $40,000. Fortress' total costs or deductions, excluding the costs of goods sold, are $6,500,000. Are Steller's performed services a principal activity?

If the election to be treated as a consolidated renderer is not made, Steller would not meet the 25-percent presumptive test. Steller's costs related to the services are 100% of its total costs. Thus, the determination of whether or not Steller's services are a principal activity would be based on the facts and circumstances.

If, however, the election is made, the combined $750,000 ($710,000 + $40,000) in costs incurred to render services to the foreign affiliates would be compared with the total costs of the group of $7,210,000 ($710,000 + $6,500,000). Because the total costs related to the services are less than 25 percent ($750,000/$7,210,000 =10.4%), the services rendered by Fortress and Steller are not considered to be a principal activity. Thus, the services are not an integral part of Fortress' or Steller's business and an allocation pursuant to IRC §482 would be based on the deemed arm's length charge of costs or deductions incurred in performing the services, or $750,000.[54]

Thus, if the services satisfy the test to be considered a principal activity, then the services performed are considered to be an integral part of the service renderer's business activity and a true arm's length charge must be used for the intercompany service fee charged a related party.

4. Peculiarly Capable And Principal Element

A true arm's length charge must be applied to services when the renderer is peculiarly capable of rendering the services and the services rendered are a principal element in the recipient's operations. The entity performing the services is peculiarly capable when the service renderer makes use of a particularly advantageous situation or circumstance such as utilization of special skills and reputation, an influential relationship with customers, or its intangible property. However, the renderer is not considered peculiarly capable unless the value of the services substantially exceeds the costs and deductions attributable to the services.[55]

This provision covers situations where services rendered are a key factor in determining the success or failure of the recipient's profit making activity, as opposed to those services which are considered supportive in nature. The peculiarly capable qualification is explained as the use of a particularly advantageous situation or circumstance, such as the utilization of special skills and reputation, the utilization of an influential relationship with customers, or the utilization of intangible property. This condition only exists when the value of the services is substantially in excess of the costs.

Example 21:

Wattage, Inc., and White Bulb Corporation are members of the same controlled group. Both engage in the manufacture of extended-life light bulbs. In the past, the product has not always operated properly because of imperfections present in the finished product. Wattage and White Bulb both own interests in an exclusive patented process, which detects and removes the imperfections prior to the sale of the product. This process greatly increases the marketability of the product. In connection with its manufacturing operations, White Bulb sends its products to Wattage for inspection utilizing the patented process because White Bulb does not have the facilities to implement the inspection process itself. Is Wattage peculiarly capable of rendering these services?

No. Because White Bulb also owns an interest in the patented process, Wattage is not peculiarly capable of rendering the inspection services to White Bulb.[56]

The regulations provide no guidelines to help determine whether the value of a service is substantially in excess of its costs, how to value the service, or even what is to be considered substantial. Usually, value is determined by reference to third-party transactions. However, if the services are supportive in nature, the renderer would not be considered to be peculiarly capable of rendering the service.[57]

Example 22:

Assume Currency Corporation is a finance company whose principal business is making automobile loans, and its sister corporation, Insure U, Inc., is an insurance agency that issues credit life insurance. The credit life insurance, if purchased, will pay off any remaining automobile loan balance should the debtor unfortunately pass away unexpectedly. Although borrowers from Currency are not required to buy credit life insurance, Currency's employees regularly suggest that such insurance be purchased from Insure U and many customers follow this suggestion because obtaining insurance from other companies often delays the processing of the loan. Is Currency peculiarly capable of rendering the services?

Yes. Because Currency uses its relationship with its customers in rendering the service, Currency is peculiarly capable of that service. The service also constitutes a principal element in Insure U's business. Thus, the charge for Currency's services for Insure U must be an actual arm's length charge because the value of the services substantially exceeds cost and Currency utilizes an influential relationship with customers in performing the service.[58]

In Borge Corporation v. Commissioner,[59] the taxpayer rendered entertainment services to his controlled corporation. The value of the services to the corporation was many times the salary he received from the corporation. This is one example of the type of special skill and reputation contemplated by the regulations.

The examples provided in the regulations seem to infer what type of services will, by description, meet the particular qualifications. Historically, none of the court cases seem to address valuing the service. Realistically, if the transaction falls under this provision, it may also fall under at least one of the other three situations. Applying one of the other situations may be an easier and better approach.

If the service renderer is peculiarly capable of rendering the services and the services are a principal element in the operations of the recipient, then the services performed are considered to be an integral part of the service renderer's business activity and a true arm's length charge must be used for the intercompany service fee charged a related party.

5. Substantial Services

Services are considered to be an integral part of a trade or business if the service recipient receives benefit of a substantial amount of services from one or more related parties during the income year. Whether the services provided to a group member are considered substantial relies first on a presumptive test, much like the test to determine whether services are a principal activity. A presumption is made that services are not a substantial benefit to the recipient if the cost of rendering the services is less than 25 percent of the total costs or deductions of the recipient for the income year.

For purposes of this 25-percent presumptive test, total costs include both direct and indirect costs and deductions of providing the services to be taken into account. The total costs of the recipient include the renderer's costs, excluding any amounts paid for such services; and excluding any amounts paid for materials included in cost of goods sold. Therefore, the 25-percent test is applied on the basis of costs excluding previously reported intercompany profit.[60]

There is no provision here for a facts and circumstances test. This seems to indicate that once the 25-percent test is met, the true arm's length charge must be used. However, the taxpayer can still establish a more appropriate price.

Finally, a three-year average is allowed to be used at the taxpayer's option, if the recipient can establish that the costs for the year being tested are abnormally low due to nonrecurring circumstances (e.g., start-up costs). If this option is elected, then the 25-percent test is calculated based on the three-year period immediately preceding the close of the income year of the recipient. Shorter than a three-period is allowable if the recipient began operations within the last three years.[61]

Example 23:

Braxton Corporation, Yuster, Ltd., and Zunder Company are members of the same controlled group. Braxton is a United States based manufacturer. Yuster and Zunder are foreign subsidiaries engaged in the distribution of Braxton's products. Both Yuster and Zunder also perform some minor assembly work on Braxton's product prior to selling the product to unrelated parties. Braxton provides a variety of services to Yuster, including billing, shipping, accounting and other general and administrative services. Zunder also renders selling and other promotional services to Yuster. The services to Yuster do not constitute one of the principal activities of either Braxton or Zunder. Yuster's total costs and deductions are $3,000,000, excluding amounts paid to Braxton and Zunder and Yuster's cost of goods sold. Yuster's costs of goods sold consists of material costs of $10,000,000; labor of $600,000; and overhead of $150,000. The total direct and indirect costs incurred by Braxton and Zunder for services provided to Yuster are $1,200,000. Are the services substantial to Yuster so that they constitute an integral part of its business?

No. Because the total costs to the renderer for the service do not exceed 25 percent, the presumption is that the services are not an integral part of Yuster's business activity. For purposes of the 25-percent test, Yuster's total costs are computed as follows:

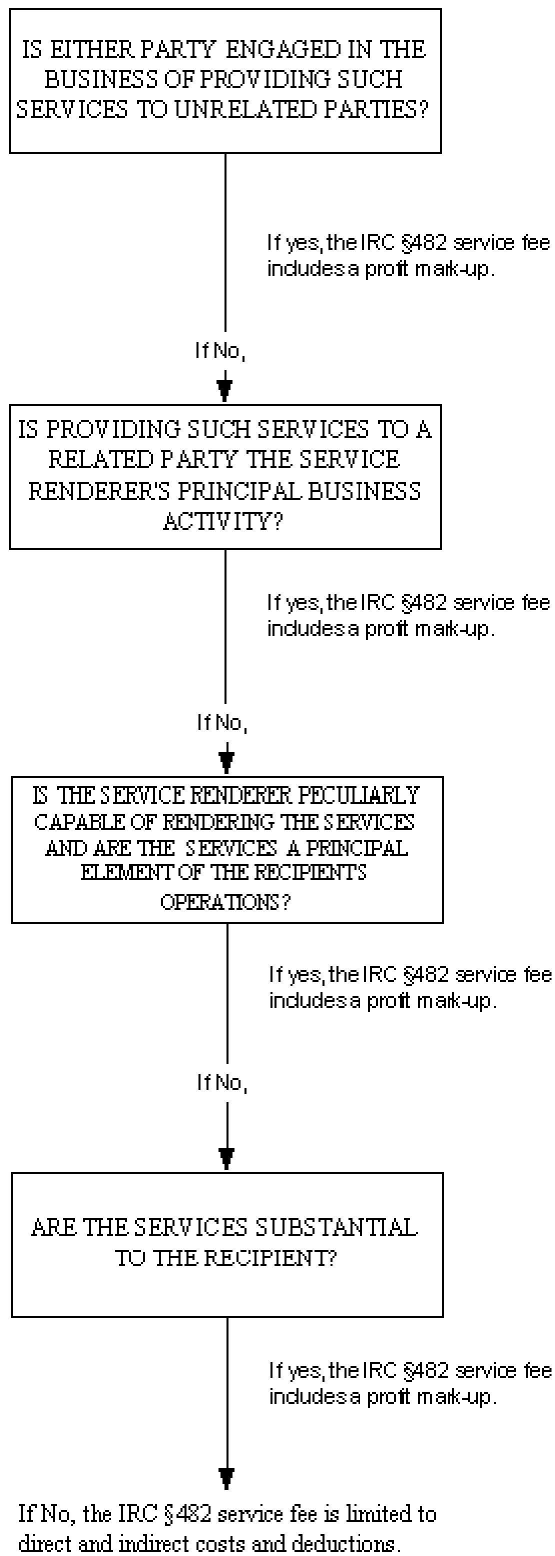
Costs and Deductions other than COGS	$ 3,000,000
Labor within COGS	600,000
Overhead within COGS	150,000
Costs of Services Provided by Related Parties	1,200,000
Total Costs	$ 4,950,000

Thus, the Braxton's and Zunder's cost of providing the services, 24 percent, does not exceed 25 percent of the Yuster's total costs ($1,200,000/$4,950,000=24%). For purposes of this 25-percent test, only material costs in the cost of goods sold are excluded from the computation of total costs.

Example 24:

Assume the same facts as those in Example 23 apply and that the income year is the period ended on December 31, 1994. Assume the costs during 1994 were abnormally low. Yuster can elect to compute the above calculation using information of the three-year period including the 1992, 1993 and 1994 calendar years.

Thus, if the service recipient has received the benefit of a substantial amount of services, then the services performed are considered to be an integral part of the service renderer's business activity and a true arm's length charge must be used for the intercompany service fee charged a related party.


IS EITHER PARTY ENGAGED IN THE BUSINESS OF PROVIDING SUCH SERVICES TO UNRELATED PARTIES?
If yes, the IRC §482 service fee includes a profit mark-up.
If No,
IS PROVIDING SUCH SERVICES TO A RELATED PARTY THE SERVICE RENDERER'S PRINCIPAL BUSINESS ACTIVITY?
If yes, the IRC §482 service fee includes a profit mark-up.
If No,
IS THE SERVICE RENDERER PECULIARLY CAPABLE OF RENDERING THE SERVICES AND ARE THE SERVICES A PRINCIPAL ELEMENT OF THE RECIPIENTS OPERATIONS?
If yes, the IRC §482 service fee includes a profit mark-up.
If No,
ARE THE SERVICES SUBSTANTIAL TO THE RECIPIENT?
If yes, the IRC §482 service fee includes a profit mark-up.
If No, the IRC §482 service fee is limited to direct and indirect costs and deductions.

If No, the IRC §482 service fee is limited to direct and indirect costs and deductions.

f. Services Rendered With The Transfer Of Property

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 the transfer, the amount of any allocation that may be appropriate with respect to such transfer is determined applying the rules that relate to either tangible property or intangible property, whichever applies. A separate allocation related to services, applying TR §1.482-2(b), will not be made.

When services are rendered in connection with the transfer of property where such services are merely ancillary and subsidiary to the transfer of the property, or to the commencement of effective use of the property by the transferee, then a separate allocation related to the services is not made. Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact. It is a normal business practice for entities selling property to perform services which are directly related to the sale. For example, ancillary and subsidiary services could be performed in promoting the transaction by demonstrating and explaining the use of the property transferred, by assisting in the operational start-up of the property transferred, or by performing under a guarantee relating to such start-up.

Example 25:

Compu Company sells a main frame system which Compu will install, provide demonstrations of use and provide training to the employees of the buyer using the system. There is no separate charge for these services. These services would be considered merely ancillary to the transfer of the data processing system. Thus, a separate charge for these services is not required pursuant to IRC §482.

Similarly, sellers of a secret process will, as part of the sale, help the buyer integrate the process into a manufacturing operation. Whether the service is performed in connection with the sale of property must be determined. If, for example, the employees of the seller continue to supervise the manufacturing operation of the seller, then a separate charge for services may be appropriate.[62]

Where an employee of one member of a group, acting under the instructions of his employer, reveals a valuable secret process owned by his employer to a related entity, and at the same time supervises the integration of such process into the manufacturing operation of the related entity, such services could be considered to be rendered in connection with the transfer of the intangible property. If so considered, such services would not be the basis for a separate allocation. However, if the employee continues to render services to the related entity by supervising the manufacturing operation after the secret process has been effectively integrated into such operation, a separate allocation with respect to such additional services may be made in accordance with IRC §482.[63]

A difficult area to address is whether the corporation acts as a contractor or as a manufacturer. As a contractor, the corporation will be considered to be rendering a service. Thus, the intercompany transfer price will be determined applying the regulations related to services. If the corporation is treated as a manufacturer, the transfer price is determined by applying the regulations related to the transfer of tangible property. Whether an entity acts as a contractor or a manufacturer is a facts and circumstances issue.

Example 26:

Amo Corporation ships raw materials to a related corporation, Seeno Company. Seeno then converts the raw materials into component parts, based on Amo's specifications. The components are then shipped them back to Amo. Seeno does not perform a purchasing function, nor does it maintain inventory stock. Is Seeno's activity a service or manufacturing? Because the activity performed by Seeno is at the direction of Amo, the manufacturing process is Amo's, Seeno does no purchasing and Seeno does not maintain any inventory, Seeno's activity would be considered to be a service.[64]

g. Example

Smith Wither Corporation, a corporation organized in California, is wholly owned by Stay-Here, Ltd., a foreign corporation. Stay-Here owns and operates a hotel chain located in various, exotic locations. Smith Wither advertises and promotes vacations for Stay-Here's various resorts. For the years under audit, Smith Wither is operating at a loss. Obviously, no corporation should perform services at a service charge where its own costs are not reimbursed. These services were Smith Wither's only activity.

A pricing issue does exist related to the services rendered by Smith Wither on behalf of its foreign parent, Stay-Here. Smith Wither's sole purpose of existence is to provide the foreign parent with promotional and other related services. TR §1.482-2(b) provides for allocations to reflect arm's length charges with respect to services performed by one member of a controlled group exclusively for the benefit of another member of the controlled group. At a minimum, Smith Wither should re-coup all expenses incurred related to these services (the deemed arm's length charge).

The first issue to address is whether or not Stay-Here intended to receive benefits from Smith Wither's activities. Smith Wither's activities were targeted strictly for the benefit of Stay-Here. The activities were not remote, nor were they a duplication of Stay-Here's activity. The first requirement is met.

The next issue is whether or not the services were an integral part of Smith Wither's business activity. If not, the arm's-length charge is deemed to be equal to the costs and deductions incurred with respect to such services by Smith Wither, unless, the taxpayer establishes a more appropriate charge. Costs considered in this determination include direct and indirect costs, but do not include: interest expense on indebtedness not incurred specifically for the benefit of another member of the group; expenses associated with the issuance of stock and maintenance of shareholder relations; and expenses of compliance with regulations or policies imposed upon the member rendering the service by its government which is not directly related to the services rendered. If the services performed are an integral part of Smith Wither's or Stay-Here's business activity, then an appropriate profit mark-up would also be included in the arm's length charge.

Of the four situations considered to be an integral part of the business activity, the first situation is whether Smith Wither or Stay-Here is engaged in the business of vacation advertising and promoting for unrelated parties. The answer to this is no. Smith Wither does not perform similar services for an unrelated party. Further, Stay-Here does not perform these services. The second situation is where the service renderer performs services for one or more related parties as one of its principal activities. The answer to this is yes. The services provided by Smith Wither's for Stay-Here is Smith Wither's principal activity. The services are considered to be an integral part of Smith Wither's business activity based on this situation. Smith Wither clearly meets the integral part test.

Accordingly, Smith Wither should not only be compensated for its direct and indirect costs, it is also be earning a profit on the activities it performs on behalf of Stay-Here.

Note an alternative position that could be argued in this case is that the expenses deducted by Smith Wither should be disallowed pursuant to IRC §162 because the services performed for the benefit of another are not paid or incurred in carrying on of the taxpayer's trade or business.

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

h. Audit Considerations

1. Obtain organizational charts to determine ownership of all domestic and foreign related companies.
2. Analyze Board of Director minutes and Executive Committee minutes, if applicable, for discussions of the intercompany performance of services, e.g., authorized personnel transfer.
3. Review domestic and foreign Annual Reports, federal Forms 1120 and 1120F, SEC Form 10-k and 20-f filings and internal reports to determine the functions of overall operations. Is the taxpayer in a highly technical business, or does it have valuable trade names or trademarks? Is the taxpayer sharing this expertise with its related entities through marketing, technical support or administrative activities?
4. Review the federal Forms 5471 and 5472. These forms should describe the foreign corporation's business activity and should contain a profit and loss statement. Obtain financial statements for relevant entities to verify amounts reported on these forms.
5. Obtain copies of service agreements with the related entities to identify terms of the intercompany transactions. If the taxpayer has service agreements with unrelated companies, these should also be obtained to determine if the terms, computations and amounts charged to the unrelated companies are comparable to the terms reflected in the related company agreements.
6. Obtain an explanation from the taxpayer describing the methods and procedures used in allocating costs between related entities. Obtain samples of the actual computations to test the reasonableness of the methods used. Determine whether the computations follow accounting principles and TR §1.482-2(b).
7. Review travel expenditures to determine if any technical or administrative personnel are visiting foreign affiliates for extended periods.
8. Determine if any foreign personnel are providing or securing substantial technical information on visits to the United States and are being compensated by the domestic companies. Payroll records may be one source to determine this item.
9. If there are indications of intercompany services for which no charge or a minimal charge is being made, request that the taxpayer furnish a detailed description of the functions actually performed, and by whom. The explanation should include functions by entity, a list of employees and the

tasks performed (e.g., administration, engineering, marketing, etc.).

For those situations where you believe an issue exists, the first question to answer before you make the calculation is whether an allocation should be made in the first place. Do not forget the benefit test!

1) Was a benefit received for services rendered?

This question is particularly important because under IRC §482 no allocation can be made without a benefit having been intended. Before you can allocate overhead or other expenses to companies or divisions, make sure you can address this question. It is not appropriate to make an allocation just because one may have been made for financial statement purposes.

2) Was the service rendered an integral part of either party's trade or business?

You must determine whether the services in question were "supportive" in nature or met one of the four situations described in the regulations. Based on your determination you will either make an allocation of the costs of rendering the services or you will need to determine the value of the services rendered, e.g., a reasonable profit mark-up. You will usually be alerted to the potential issue where deductions have been claimed for management fees, commissions or consulting fees paid or received from related parties.

3) What are the costs?

Whether your allocation is for actual costs or an arm's length charge, you must determine applicable direct and indirect costs. Although the regulations provide a deemed arm's length charge, determining the full direct and indirect costs can be difficult. It is very important to obtain a good understanding of the taxpayer's and related entities' operations and accounting system to determine if the full costs of services are reflected.

a. Analyze all intercompany accounts payable and receivable to determine what was charged between companies.
b. Budget variance reports will often show how expenses are allocated to divisions and cost centers. Many variance reports will show expenses by organizational codes, by center codes, or by general ledger account numbers. These reports can be very helpful. Also, find out if the

organization uses an internal billing system, (e.g., if the research and development department is billed $100 a page for typing services from the administrative department, you know there is a problem.)

c. Determine the basis upon which indirect expenses are allocated and apportioned (e.g., hours, square footage, estimates, etc.,). Decide if the allocation system applied by the taxpayer is reasonable. Chances are an issue will arise when the taxpayer has no system in place.

d. Remember to subtract from indirect costs the non-allowed interest expense, expenses associated with stock issuance or reorganizations, etc., and expenses associated with governmental regulation compliance.

4) What is the Arm's Length Charge for the Services?

The regulations provide no guidelines as to how the profit mark-up is to be determined. Where the renderer is in the business of rendering similar services to unrelated parties, a comparable uncontrolled transaction can usually be found.

For example, assume an auditor makes an IRC §482 adjustment for engineering services to a related controlled foreign corporation. The auditor first identifies what employees performed the service. Then, applying the hourly rate charged to the unrelated parties based upon the particular engineer's experience level, makes an appropriate adjustment. The auditor was able to identify the engineers using their payroll numbers. The engineers were required to account for their time spent by job. The company computed progress billings for labor, based on hours spent by payroll number on the particular job.

In other situations, determining an arm's length charge is quite difficult. If IRS practice in the past is any guide, IRC §482 adjustments could be based on cost plus a reasonable percentage mark-up. However, what is reasonable will certainly be discretionary. To defend that an adjustment is reasonable, it is best to base an adjustment on similar service organizations, assuming some exist, applying reasonable criteria, e.g., return on assets used to render the services, common financial ratios, etc.

5) Are There Other Alternatives?

Remember that a number of issues may be applicable to the transactions discovered, e.g., an IRC §162 ordinary and necessary issue, a possible assignment of income issue, a subpart F income determination issue, or allocation issues pursuant to other IRC §482 regulation sections. You should identify the issues and develop a strategy that will strengthen your position on one or more primary and alternative issues.

i. Summary

1. 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.
2. 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.
3. A arm's length charge must be applied. The arm's length charge is deemed to be the direct and indirect costs of providing the services unless the services provided are an integral part of either party's trade or business or unless the taxpayer demonstrates another price is a more appropriate arm's length charge.
4. If the services provided are an integral part of the trade or business, the amount to be allocated would be the amount that would have been charged to an unrelated recipient in a similar situation. Thus, a reasonable profit mark-up would be included in this arm's length charge.
5. Services are an integral part of a trade or business when:
   a. Either member renders similar services to unrelated parties;
   b. The services rendered are a principal activity of the renderer (25-percent test);
   c. The renderer is peculiarly capable of rendering the services and they are a principal element of the recipient's operations; or
   d. The recipient has received the benefit of a substantial amount of services from one or more related parties (25-percent test).
5. 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 TR §1.482-2(b) is not made.

This section discussed the application of IRC §482 and TR §1.482-2(b) to services performed for or on behalf of a related party. Section 18.4, Water's-Edge Manual will discuss the application of IRC §482 and TR §1.482-2(c) to the intercompany use of tangible property.

Footnotes

1. Treasury Regulations (TR) §1.482-2(b)(1).
2. Transfer Pricing: The Code and The Regulations, Tax Management Foreign Income Portfolios (BNA) No. 887, by John P. Warner, Esq., page A-38.
3. Leedy-Glover Realty and Insurance Company v. Commissioner, 13 TC 95 (1949), aff'd per curiam, 184 F2d 833 (5th Circuit 1950).
4. Ibid., note #2, page A-37.
5. TR §1.482-2(b)(2)(i).
6. Ibid., note #5, Example (1).
7. Ibid., note #5, Example (2).
8. Ibid., note #5.
9. Ibid., note #5.
10. Ibid., note #5, Example (3).
11. TR §1.482-2(b)(2)(ii).
12. Ibid., note #11, Example (1).
13. *International Issues*, Phase I, Module I, by IRS, Training No. 3135-217, dated November 1993, page I-3-4.
14. Columbian Rope Company v. Commissioner, 42 TC 800 (1964), acq'd, 1965-1 Cumulative Bulletin (CB), page 4.
15. Young and Rubicam, Inc., v. United States, 540 F2d 740 (Ct. Cl. 1977).
16. Ibid., note #2, page A-39.
17. TR §1.482-2(b)(3).
18. Ibid., note #2, page A-38.
19. Ibid., note #17
20. TR §1.482-2(b)(4).
21. TR §1.482-2(b)(4).
22. TR §1.482-2(b)(4)(ii).
23. TR §1.482-2(b)(4)(iii).
24. Ibid., note #23.
25. TR §1.482-2(b)(5)(i), (ii) and (iii).
26. TR §1.482-2(b)(6).
27. TR §1.482-2(b)(6)(ii).
28. Ibid., note #13, page I-3-21.
29. Ibid., note #27.
30. Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of §482, by Surrey, Journal of Tax, Volume 28, pages 75, 78 (1968).
31. Ibid., note #17.

32. TR §1.482-2(b)(6)(i).
33. TR §1.482-2(b)(6)(iii). Fundamentals of International Taxation, US Taxation of Foreign Income and Foreign Taxpayers, by Boris I. Bittker and Lawrence Lokken, Second Edition 1991, 79.3.3, page 79-18.
34. TR §1.482-2(b)(6)(iii).
35. TR §1.482-2(b)(7)
36. TR §1.482-2(b)(7)(i).
37. TR §1.482-2(b)(7)(ii).
38. TR §1.482-2(b)(7)(iii).
39. TR §1.482-2(b)(7)(iv).
40. Ibid., note #13, page I-3-6.
41. Ibid., note #40.
42. Fundamentals of International Taxation, US Taxation of Foreign Income and Foreign Taxpayers, by Boris I. Bittker and Lawrence Lokken, Second Edition 1991, 79.3.3, page 79-16.
43. TR §1.482-2(b)(7)(ii)(A).
44. TR §1.482-2(b)(7)(ii)(B).
45. TR §1.482-2(b)(7)(v), Example 8.
46. TR §1.482-2(b)(7)(v), Example 2. Ibid., note #13, page I-3-8.
47. Ibid., note #43.
48. TR §1.482-2(b)(7)(v), Example 9. Ibid., note #13, page I-3-8.
49. TR §1.482-2(b)(7)(v), Example 7. Ibid., note #13, page I-3-12.
50. TR §1.482-2(b)(7)(v), Example 3. Ibid., note #13, page I-3-8.
51. TR §1.482-2(b)(7)(ii)(C).
52. Ibid., note #51.
53. TR §1.482-2(b)(7)(v), Example 4.
54. Ibid., note #53. Ibid., note #13, page I-3-10. Ibid., note #2, page A-43.
55. Ibid., note #38.
56. Ibid., note #53, Example 13.
57. Ibid., note #13, page I-3-14.
58. TR §1.482-2(b)(7)(v), Example 10. Ibid., note #42, 79.3.3, page 79-17.
59. Borge Corporation v. Commissioner, 26 TCM 816 (1967), 405 F2d 673 (1969), cert. denied, 395 US 933 (1969).
60. Ibid., note #39.
61. TR §1.482-2(b)(7)(iv). Ibid., note #42, 79.3.3, pages 79-17 through 79-18.
62. TR §1.482-2(b)(8).
63. Ibid., note #62.
64. Ibid., note #13, page I-3-22.

Section 18.4 Intercompany Transfer Pricing Use Of Tangible Property

Contents:

a. Introduction
b. In General
c. Arm's Length Rental Charge
d. Safe Haven Rental Charge
e. Subleases
f. Coordination With Other Code Sections
g. Audit Considerations
f. Summary

References:

Revenue and Taxation Code §24725
Revenue and Taxation Code §25114
California Code of Regulations §25114
Internal Revenue Code §482
Treasury Regulations §1.482-1
Treasury Regulations §1.482-2(c)

Training Objectives:

This section of the chapter will discuss the specific application of Internal Revenue Code (IRC) §482 to the intercompany use of tangible property. At the end of §18.4, you will have a basic understanding of Treasury Regulation (TR) §1.482-2(c), including when the arm's length rental charge or the safe haven rental charge is applicable, what costs should be considered when determining the appropriate intercompany rental charge, and considerations for audit.

a. Introduction

Section 18.1, Water's-Edge Manual discussed the general concepts of IRC §482 while Section 18.2, Water's-Edge Manual discussed the application of TR §1.482-2(a) to loans and advances between related parties and Section 18.3, Water's-Edge Manual discussed the application of TR §1.482-2(b) to the performance of services for or on the behalf of a related party. This section will specifically address the third type of transaction contemplated by TR §1.482-2, the rules related to the intercompany use of tangible property.

The rules related to the intercompany use of tangible property did not change with the 1993 temporary regulations nor the 1994 finalized regulations. The rules remain within TR §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.

TR §1.482-2(c) is the shortest section within all of the regulations pursuant to IRC §482. In general, application of TR §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.[1]

For leases of tangible property entered into before May 9, 1986, the regulations contained a safe haven rental charge, which could be used only if the lessor and the lessee were not in the trade or business of leasing property. For leases entered into after May 9, 1986, the safe haven rental rate is no longer available.

In addition to the application of IRC §482, another viable approach to attack the problem of the intercompany use of tangible property is to disallow rental deductions claimed pursuant to IRC §162, Revenue and Taxation Code (RTC) §24343, when costs incurred for the use of such property, with respect to the carrying on of the taxpayer's trade or business, are not ordinary and necessary business expenses as defined by IRC §162.

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.

The circumstances to be considered when determining the arm's length rental rate include the:

1. Period (of time) and location of the tangible property;
2. Owner's investment in the tangible property, or rent paid for the tangible property (in case of a sublease);
3. Expenses of maintaining the tangible property or maintaining the lease;
4. Type of tangible property involved and its condition; and
5. All other *relevant* facts.[2]

Example 1:

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.

As in the case of intercompany loans and the intercompany performance of services, discussed in §18.2 and §18.3, in addition to the arm's length rental charge the regulations also provide a safe haven rental charge.

d. Safe Haven Rental Charge

The regulations containing the safe haven rental charge were amended in 1988.[3] The safe haven rental charge only applies to leases entered into before May 9, 1986, or leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986. These leases are covered by the safe haven rental charge until the expiration of the lease. Therefore, for leases entered into after that date, only the true arm's length rental charge can be applied.

For those leases entered into before May 9, 1986, the safe haven rental charge is the sum of:
1. The current year's depreciation expense; plus,
2. Three percent of the depreciable cost basis of the tangible property; plus,
3. The direct and indirect expenses connected with the tangible property or the lease, excluding interest expense.

If the taxpayer can establish a more appropriate rental charge by reference to third-party transactions, then that charge will be the arm's length rental charge.

Example 2:

Since November 1, 1983, Pesto Company, who is not in the business of renting property, has leased a warehouse located in an undesirable, run-down area to its wholly owned subsidiary, Noodle, Ltd. The annual safe haven rental charge is $75,000. Based on third-party transactions, Pesto can demonstrate that similar warehouse space in the same area leases for only $50,000 a year. The appropriate arm's length rental charge pursuant to IRC §482 for Noodle's lease would be $50,000.[4]

For purposes of the safe haven rental charge,[5] the following should be noted. The amount of depreciation is calculated by dividing the depreciable basis of the tangible property by its total useful life in the hands of the legal owner. The depreciable basis is the original cost or other basis of the tangible property, adjusted by capital improvements and reduced by any salvage value. However, the basis is not reduced for any amount attributable to exhaustion, wear and tear, and obsolescence.

The total useful life, depreciable basis and salvage value are estimated based on the facts and circumstances, known to exist at the time of the lease. If capital improvements or adjustments are made to the tangible property after the commencement of the lease, the basis of the tangible property is adjusted when total improvements become substantial and result in the redetermination of the rental charge per the lease agreement. Improvements or adjustments are considered substantial when the total improvement costs exceed 25 percent of the adjusted basis of the tangible property.[6]

Example 3:

Assume an industrial sewing machine has an unadjusted basis of $10,000, no salvage value and has a ten-year useful life upon acquisition. For a lease signed in 1984, the safe haven rental charge for one year would be $1,300 (1/10th X $10,000=$1,000; plus 3% X $10,000=$300).[7]

Costs considered are those paid or accrued by the legal owner or the lessor during the income year. These costs include property taxes, repairs, maintenance, utilities and management expenses, as well as the cost of services rendered which are ancillary and subsidiary to the transfer of the property under the lease agreement. Capital expenditures are considered includible expenses to the extent they may be amortized over the taxable year. Interest expense is not included in this calculation.[8]

Example 4:

On January 1, 1985, Ally Corporation, not in the business of renting property, leased a machine to its subsidiary, Dress Company. The machine was purchased by Ally on January 1, 1975, for $100,000. Before leasing the machine to Dress, Ally used it in its business and claimed depreciation of $50,000, based on an original estimated useful life of 20 years. Thus, on January 1, 1985, the adjusted basis of the machine, after ten years of use, was $50,000.

During the 1990 income year, Ally paid the following expense with respect to the leased tangible asset:

Interest	$ 500
Repairs	500
Other maintenance	500
Total	$1,500

As of January 1, 1990, the fair market value of the machine was $300,000 and the arm's length rental was $20,000, based on third-party transactions. The machine had no salvage value. Because Ally and Dress are not in the business of leasing similar tangible property to unrelated parties and their lease was transacted before May 9, 1986, the taxpayer can apply the safe haven rental charge. This charge is computed as follows:

For 1990:	
Depreciation Expense ($100,000/20 years)	$ 5,000
Three Percent of $100,000	3,000
Repair Expense	500
Other Maintenance	500
Total	$ 9,000

Note: Depreciation claimed by Ally before the asset was leased does not reduce the basis of the property when computing the depreciation and the three percent components of the safe haven rental rate. Note$_2$: Three percent of the depreciable basis of the leased property is intended to represent a return on capital.[9]

The safe haven rental charge does not apply to lease transactions where either the lessor or related lessee is engaged in the trade or business of renting or leasing tangible property. Owners or users of tangible property are not considered to be engaged in the trade or business of renting property of the same general type when they only causally or infrequently rent property that is used predominately in their trade or businesses.[10]

Example 5:

Sunrise Corporation operates a repair business for large equipment used in large-scale farming. The majority of Sunrise's income and business activity relate directly to its repair business. Occasionally, Sunrise rents equipment not currently in use to local farmers. This occasional rental activity would not constitute a rental trade or business of tangible property for purposes of IRC §482.

Example 6:

Assume the same facts as in Example 5 above, except in addition to its repair business, Sunrise also acquires discarded or old farm equipment and refurbishes the equipment. On a regular basis, the re-built equipment is rented or leased. This activity would be sufficient to be considered a trade or business of renting property.

Also, the safe haven rental charge cannot be applied to tangible property which is nondepreciable or has no determinable useful life, e.g., land. Why this property was omitted is not clear. The regulations provide no additional explanation. One possible position is that a separate true arm's length rental charge should be determined for this property if it is a significant element in the owner's basis.[11] However, in Fegan Corporation v. Commissioner,[12] the basis in its land was simply excluded from the computation. No separate charge for the land was made. This may have been an oversight. The position taken by the Internal Revenue Service, as a logical approach when nondepreciable property is leased, is to compute a separate charge, based on the arm's length rental charge as opposed to a safe haven rental charge.[13]

Further, if the tangible property is used by more than one party, whether related or unrelated, during the income year, then only a portion of the sum of the expenses would be taken into account with respect to each user. The amount to be taken into account would be number of days used by the lessee divided by the number of days leased by all parties multiplied by the safe haven rental charge.

Example 7:

Buster Corporation owns a warehouse in Ireland, which it leases to an unrelated party from January 1 to June 30, 1985. On July 1, 1985, Buster leases the warehouse to its newly formed foreign subsidiary, Dublin, Ltd. After leasing the warehouse to Dublin, neither Buster nor Dublin leased property of the same general type to unrelated parties. The safe haven rental charge, pursuant to IRC §482, is $10,082 (184 days/365 days X $20,000=$10,082).[14]

e. 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 sublessee or the user, attributable to the period during which the tangible property is used.[15] 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 then applying the safe haven rental charge.[16]

Example 8:

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.[17]

f. 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.

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.[18]

It may also be necessary to coordinate IRC §482 and IRC §467, Certain Payments for Use of Property or Services. RTC §24688, which conforms to IRC §467, is effective for income years beginning on or after January 1, 1985.[19] 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 TR §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.[20] Regardless of TR §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 TR §1.482-2(a).

g. Audit Considerations

1. Obtain organizational charts to determine ownership of all domestic and foreign companies.
2. Analyze Board of Directors minutes and Executive Committee minutes, if applicable, for discussion of lease agreements between related entities.
3. Analyze the federal Forms 1120, federal Forms 1120F, SEC Form 10-k and 20-f filings, domestic and foreign Annual Reports and internal reports. Notice any holding companies which may legally own assets being leased. Notice any business descriptions that indicate the entity's trade or business is the leasing of tangible property. Review the accounts receivable and accounts payable to identify potential intercompany rental or lease payments.
4. Analyze the federal Forms 5471 and 5472. These forms should describe the foreign corporation's business activity and should contain a profit and loss statement. Identify entities where the business description is the leasing of tangible property. Obtain financial statements for relevant entities to verify amounts reported on these forms. Pay particular attention to the following:
   a. Income Statement - Are there any deductions for rent expense? Is there rental income?
   b. Balance Sheet - Review beginning and ending balances of the accounts receivable, accounts payable and other liabilities for significant changes.
5. Review the footnotes to the domestic and foreign financial statements to identify lease commitments between related entities.
6. Obtain copies of relevant lease agreements to identify terms of the intercompany transactions. Compare the terms of the agreement with the actual rents or lease payments made; or, rental or lease income received from the related entities. If the taxpayer has lease agreements with unrelated entities, obtain copies of these agreements to determine if the terms, computations and amounts charged to the unrelated companies are comparable to the terms reflected in the related company agreements.
7. Determine the commencement date of the lease agreements to determine if the lease was entered into before May 9, 1986, and whether or not the safe haven rental charge can be applied.
8. Determine if the lease is a sublease. If so, the safe haven rental charge can be applied regardless of the commencement date of the lease. The

computation of the safe haven rental charge for a sublease includes all appropriate expenses claimed by the lessee, not the sublessee or the user.

9. If the safe haven rental charge was applied, obtain an explanation from the taxpayer describing the costs considered in determining the lease charge. If the lease is not a sublease, ensure interest expense is excluded. Ensure the corporation is not in the business of leasing tangible property and that the proper computation was made.
10. If there are indications of intercompany leases for which no charge or a minimal charge is being made, request that the taxpayer furnish a detailed description of the terms of the lease. The explanation should include how the tangible property is used and the location(s) where the tangible property is used.
11. Consider other applicable code sections prior to applying IRC §482. Identify the issues and develop a strategy which will strengthen your position on one or more primary and alternative positions.

h. Summary

1. TR §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.
2. For leases entered into before May 9, 1986, and binding contracts written before that date for leases entered into before August 7, 1986, the safe haven rental charge may be applied for the lease. These leases may continue to apply the safe haven rental charge until the expiration of the lease. A true arm's length rental charge must be applied to all leases entered into after May 9, 1986, with the exception of subleases.
3. 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.
4. 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.
5. 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.
6. 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; and other similar expenses.
7. When considering an issue under the regulations pertaining to the use of tangible property, one should consider the impact of any other pertinent code section, such as IRC §467, on the transaction.

This section discussed the application of IRC §482 and TR §1.482-2(c) to the intercompany use of tangible property. Section 18.5, Water's-Edge Manual will discuss the effect on intercompany transactions of the regulations finalized in 1994.

Footnotes

1. Treasury Regulations (TR) §1.482-2(c)(1).
2. TR §1.482-2(c)(2)(i).
3. Treasury Document 8204, 53 Federal Register 18276, dated May 23, 1988.
4. *International Issues*, Phase II, Module A, by the Internal Revenue Service, Training No. 3135-401, dated March 1994, page A-1-3.
5. TR §1.482-2(c)(2)(ii).
6. Ibid., note #4, page A-1-4.
7. Transfer Pricing: The Code and The Regulations, Tax Management Foreign Income Portfolios (BNA) No. 887, by John P. Warner, Esq., page A-47.
8. Ibid., note #6.
9. Ibid., note #4, page A-1-5.
10. TR §1.482-2(c)(2)(i), 26 CFR Part 1, revised as of April 1, 1985.
11. Ibid., note #7.
12. Fegan Corporation v. Commissioner, 71 TC 791 (1979), aff'd 81-1 USTC 9436 (10th Circuit 1981).
13. Ibid., note #4, page A-1-9.
14. Ibid., note #4, page A-1-7.
15. TR §1.482-2(c)(2)(iii)(A).
16. TR §1.482-2(c)(2)(iii), 26 CFR Part 1, revised as of April 1, 1985.
17. Ibid., note #14.
18. 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).
19. Revenue and Taxation Code §24688 was added by Senate Bill 572, effective for income years beginning on or after January 1, 1987.
20. Ibid., note #7.

Section 18.5 Intercompany Transfer Pricing - Key Components Of The 1994 Final Regulations

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I. Summary

References:

Revenue and Taxation Code §24725
Revenue and Taxation Code §25114
California Code of Regulations §25114
Internal Revenue Code §482
Treasury Regulations §§1.482-1(c), (d), (e), (h), (i) and (j)
Treasury Regulations §1.482-3
Treasury Regulations §1.482-4

Training Objectives:

This section will discuss the Treasury Regulations (TR) that were finalized in 1994 pursuant to Internal Revenue Code (IRC) §482. The 1994 regulations created new concepts to be applied in determining the intercompany transfer price for the transfer of tangible and intangible property. At the end of this Section, you will have a basic understanding of the overall changes caused by the 1994 regulations, including the best method rule and the significance of comparability.

a. Introduction

Section 18.1, Water's-Edge Manual, discussed the general concepts of IRC §482, while Section 18.2, Water's-Edge Manual through Section 18.4, Water's-Edge Manual discussed the application of TR §§1.482-2(a), (b) and (c) to intercompany loans, the intercompany performance of services and the intercompany use of tangible property. This section will specifically discuss the new concepts created by the 1994 regulations.

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 effect 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.
    a. The best method rule must be applied to select the most reliable measure of arm's length results from the available evidence.
    b. The best method rule guides the application of all methods.
    c. 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 of two methods 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. Three factors must be considered for purposes of evaluating the underlying data and assumptions used in the best method rule. These include the:
    a. Completeness and accuracy of data;
    b. Reliability of the assumptions made; and
    c. Sensitivity of results to deficiencies in the data and assumptions used.
8. Adjustments must be made to consider material differences if the effect of the difference can be ascertained with sufficient accuracy to improve the reliability of the results.[1]

Prior to the 1994 regulations, there were four accepted transfer pricing methods. Further, the methods had a hierarchy in usage that had to followed. In other words, the first method had to be applied first and it had to be demonstrated that the first method could not be applied before applying the second method. It then had to be demonstrated whether or not the second method could be used. If not, then the third method could be applied and so on. The prior methods included the:

1. Comparable Uncontrolled Price (CUP) Method;
2. Resale Price Method;
3. Cost Plus Method; and
4. Fourth Method.

The following methods now apply for the transfer of tangible property and are discussed in Section 18.6, Water's-Edge Manual. These include the:

1. Comparable Uncontrolled Price (CUP) Method;
2. Resale Price Method;
3. Cost Plus Method;
4. Comparable Profits Method;
5. Profit Split Method; and
6. Unspecified Methods.

For the transfer of intangible property, the 1968 regulations only provided two methodologies, unlike the several specified for the transfer of tangible property. One method allowed was the comparable uncontrolled transaction (CUT) method, which was comparable to the CUP method. Otherwise, the 1968 regulations provided factors to consider for a facts and circumstances analysis. The 1994 regulations specify four methods that apply for the transfer of intangible property. These methods are discussed in Section 18.7 Water's-Edge Manual, and include the:

1. Comparable Uncontrolled Transaction (CUT) Method;
2. Comparable Profits Method;
3. Profit Split Method; and
4. 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.[2]

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.[3]

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.[4]

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:

1) Completeness and accuracy of the underlying data;
2) Reliability of the assumptions made; and
3) Sensitivity of the results to the possible deficiencies in the data and assumptions.[5]

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.[6]

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.[7]

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 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.[8]

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.[9]

Thus, the best method rule replaces the strict priority of methods contained in the 1968 regulations.[10] 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.[11]

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:

1) Functions performed by the entities and the associated resources employed;
2) Relevant contractual terms of the transactions;
3) Risks incurred by the various affiliated entities;
4) Relevant economic conditions of the various markets; and
5) Any items of property provided or services performed.[12]

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.[13]

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.

Functions that may need to be accounted for in determining comparability of two transactions include:

1. Research and development;
2. Product design and engineering;
3. Manufacturing, production and process engineering;
4. Product fabrication, extraction and assembly;
5. Purchasing and materials management;
6. Marketing and distribution functions, including inventory management, warranty administration and advertising activities;
7. Transportation and warehousing; and
8. Managerial, legal, accounting, finance, credit and collection, training and personnel management services.[14]

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:

1. Form of consideration charged or paid;
2. Sale or purchase volume;
3. Scope and terms of warranties provided;
4. Rights to updates, revisions or modifications;
5. Duration of relevant license, contract or other agreements, and termination or re-negotiation rights;
6. Collateral transactions or on-going business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and
7. Extensions of credit and payment terms.
8.

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 comparability adjustment is required even if no interest would be allocated or imputed pursuant to TR §1.482-2(a) or other applicable provisions of the IRC.[15]

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.[16]

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.[17]

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:

1. Market risks, including fluctuations in cost, demand, pricing and inventory levels;
2. Risks associated with the success or failure of research and development activities;
3. Financial risks, including fluctuations in foreign currency rates of exchange and interest rates;
4. Credit and collection risks;
5. Product liability risks; and
6. General business risks related to the ownership of property, plant and equipment.[18]

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:

1. 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;
2. 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; and
3. 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.[19]

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:

1. Similarity of geographic markets;
2. Relative size of each market, and the extent of the overall economic development in each market;
3. Level of the market, e.g., manufacturer, distributor, wholesaler, retailer or customer;
4. Relevant market shares for the products, properties, or services transferred or provided;

5. Location-specific costs of the factors of production and distribution;
6. Extent of competition in each market with regard to the property or services under review;
7. Economic condition of the particular industry, including whether the market is in contraction or expansion; and
8. Alternatives realistically available to the buyer and seller.[20]

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 Section 18.7, Water's-Edge Manual. 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:

1) 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;
2) 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
3) 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.[21]

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.[22] 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.[23]

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.[24]

For example, Couture, a United States apparel design corporation, contracts with Sewco, its wholly owned Philippine subsidiary, to manufacture its clothes. Costs of operating in the Philippines are significantly lower than the operating costs in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge that could not be acquired by actual or potential competitors to Sewco at reasonable costs. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco in geographical markets that are similar to the Philippines. Thus, the fact that production is less costly in the Philippines will not, in and of itself, justify additional profits derived from lower operating costs in the Philippines inuring to Sewco, because the competitive positions of the other actual or potential producers in similar geographical markets capable of performing the same functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.

4. Unreliable Comparables

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

1) They are not made in the ordinary course of business; or
2) One of the principal purposes of the uncontrolled transaction was to establish an arm's length result with respect to the controlled transaction.[25]

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.[26]

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.[27]

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.[28]

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.[29]

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.[30]

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.[31] 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.[32]

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.[33]

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

1) When complete and accurate data for the income year under review is not available;
2) When the business cycles within a taxpayer's industry have some effect not reflected in the income year being examined; and
3) When an individual product life cycle needs further examination beyond the immediate income year being examined.[34]

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 and for the comparable profits method.[35]

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:

1) Restrictions are publicly promulgated and generally applicable;
2) 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;
3) 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
4) Related parties did not engage in transactions to circumvent restrictions.[36]

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:

1) Establish that payment or receipt of an otherwise arm's length amount was prevented because of an applicable foreign legal restriction described in TR §1.482-1(h)(2)(ii); and
2) Elect the deferred income method of accounting.[37]

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 Advanced Pricing Agreement (APA). The negotiation and approval of an APA an be a lengthy process, so the IRS also offers a streamlined APA process for smaller taxpayers. The APA program was started in 1991. By 1999, more than 180 APAs had been finalized and approximately 195 APA requests were pending.

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. Many of the proposals that have been filed address either a limited geographical area or product, or a particularly troublesome area for the taxpayer.

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.[38]
Auditors should note, however, that 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. Comparison Of The Regulations

The following charts compare the regulations finalized in 1994 to the temporary regulations issued in 1993 and the 1968 regulations for the major concepts present in the regulations.

1994 FINAL REGULATIONS[39]

Arm's Length Standard

The standard is met if the results of a transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. As a practical matter whether a transaction produces an arm's length result will be determined by reference to the results of comparable transactions under comparable circumstances.

Arm's Length Range

Ordinarily determined by applying a single pricing method, selected under the best method rule, to two or more uncontrolled comparables.

Safe Harbor

Reserved.

Foreign Legal Restrictions/ Blocked Income

Foreign legal restrictions, defined in TR §1.482-1(h)(2)(ii), are taken into account to the extent they affect the results of transactions at arm's length. If evidence of arm's length dealings is unavailable, then deferred income of accounting may be elected.

Selection Of Methods

Best Method Rule - use the method that provides the most reliable measure of an arm's length result. Focus on comparability, data and assumptions.

Methods: Tangible Property

Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Comparable Profits Method, Profit Split Method and Unspecified Methods.

Methods: Intangible Property

Comparable Uncontrolled Transaction Method, Comparable Profits Method, Profit Split Method and Unspecified Methods.

Profit Split Method

Allocation of combined profit or loss by reference to the relative value of each controlled taxpayer's contribution, based on functions performed, risks borne and resources employed.

Periodic Adjustments

The consideration charged for an intangible asset may be adjusted in a later year, subject to exceptions.

Cost Sharing

TR §1.482-7T (1968 provisions) applies. Regulations proposed in 1992 regarding cost sharing have not been withdrawn and will be the basis of the final regulations when issued.

Coordination With IRC §936

A cost share payment for purposes of IRC §936(h)(5)(C) (i)(1) must be at least equal to the payment that would be required under TR § 1.482-1 and TR § 1.482-4 through TR§1.482-6.

Lump Sum Payments

Subject to the commensurate with income standard. The lump sum amount is treated as an advance payment of a stream of royalties over the useful life of the intangible asset, or the period covered by an agreement, if shorter.

Multiple-Year Range

Compare the controlled taxpayer's average result for the multiple year period with the range of average results derived from uncontrolled comparables for the same period. If controlled taxpayer is outside the range, the taxpayer's results will be adjusted for the income year to the mid-point of the uncontrolled comparable results for the income year, but only to the extent it would move the controlled taxpayer's multiple-year average closer to the multiple-year arm's length range.

1993 Temporary Regulations[40]

Arm's Length Standard

Uncontrolled taxpayers engaging in comparable transactions under comparable circumstances (TR §1.482-1T(b)(1)). The same standard as in the 1968 regulations and the 1994 regulations.

Arm's Length Range

Determined by applying a single pricing method using two or more uncontrolled comparables (TR §1.482-1T(d)(2)).

Safe Harbor

Available for small taxpayers with less than $10 million in total revenue (TR §1.482-1T(f)(1)).

Foreign Legal Restrictions/ Blocked Income

Provides detailed requirements to elect deferred income method of accounting, (proposed TR §1.482-1T(f)(2)) which has stricter requirements than under the 1968 regulations.

Selection Of Methods

Best Method Rule (TR §1.482-1T(b)(2)(iii)(A)).

Methods: Tangible Property

Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method, Comparable Profits Method, Profit Split Method (proposed only) and Other Method.

Methods: Intangible Property

Comparable Uncontrolled Transaction Method, Comparable Profits Method, Profit Split Method (proposed only) and Other Method.

Profit Split Method

Permitted under limited circumstances (proposed TR §1.482-6T).

Periodic Adjustments

Required for transfers of intangible assets, with limited exceptions (TR §1.482-4T(e)(2)).

Cost Sharing

TR §1.482-7T applies. Regulations proposed in 1992 regarding cost sharing have not been withdrawn.

Coordination With IRC §936

A cost share payment for purposes of IRC §936(h)(5)(C) (i)(1) must be at least equal to the payment that would be required under TR §1.482-1T through TR §1.482-5T.

Lump Sum Payments

Reserved.

Multiple-Year Range

Not addressed.

1968 REGULATIONS[41]

Arm's Length Standard

An uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Arm's Length Range

Not permitted.

Safe Harbor

Not addressed.

Foreign Legal Restrictions/ Blocked Income

Permits election of deferred income method of accounting (TR §1.482-1A(d)(6)).

Selection Of Methods

Strict priority of methods.

Methods: Tangible Property

Comparable Uncontrolled Price Method, Resale Price Method, Cost Plus Method and the Fourth Method.

Methods: Intangible Property

Comparable Uncontrolled Transaction Method and facts and circumstances.

Profit Split Method

Not addressed.

Periodic Adjustments

Not addressed.

Cost Sharing

Cost sharing arrangement must reflect an effort in good faith by the participants to bear their respective share of the costs and risks of development on an arm's length basis (TR §1.482-2A(d)(4)).

Coordination With IRC §936

No coordination rule.

Lump Sum Payments

Not addressed.

Multiple-Year Range

Not addressed.

k. Effective Dates

1. In General

The general effective date of the regulations finalized in 1994 is for income years beginning after October 6, 1994. However, taxpayers may elect to apply the regulations to any open income year.[42] The temporary regulations have the general effective date of income years beginning after April 21, 1993, but before the effective date of the final regulations.[43] The regulations that were proposed in 1992 have no effect.[44]

For the transfer of tangible property, the general effective date applies. For the transfer of intangible property, the general effective date applies, with the following exceptions:

1) For income years beginning after December 31, 1986, taxpayers may choose to apply the methods, or their underlying general principles, contained in the final regulations to implement the commensurate with income requirement. The IRS considers the final regulations to be a reasonable interpretation of the commensurate with income standard.[45]
2) For continuing transactions involving transfers or licenses of intangible property entered into before the effective date of the Tax Reform Act of 1986, refer to Chart 1 and Chart 2 below.

2. Income Years Beginning Before April 21, 1993

1) In general apply the 1968 regulations, which were re-numbered to TR §1.482-1A and §1.482-2A.[46]
2) The taxpayer must use some reasonable method to comply with commensurate with income standard for all income years beginning after December 31, 1986.[47]
3) Commensurate with income standard does not apply to transfers to foreign persons before November 17, 1985, or to transfers to others before August 17, 1986, **unless** the property subject to the transfer either did not exist or was not owned by the taxpayer at such dates.[48]

3. Income Years Beginning Before October 6, 1994, And After April 21, 1993

1) In general apply the 1993 temporary regulations, but the 1968 cost sharing regulations still apply.[49]
2) The taxpayer must comply with the commensurate with income standard for all years beginning after December 31, 1986, and any method found in the regulations is deemed compliance.[50]
3) Commensurate with income standard does not apply to transfer to foreign persons before November 17, 1985, or to transfers to others before August 17, 1986, **unless** the property is subject to the transfer either did not exist or was not owned by the taxpayer at such dates.[51]

4. Income Years Beginning After October 6, 1994

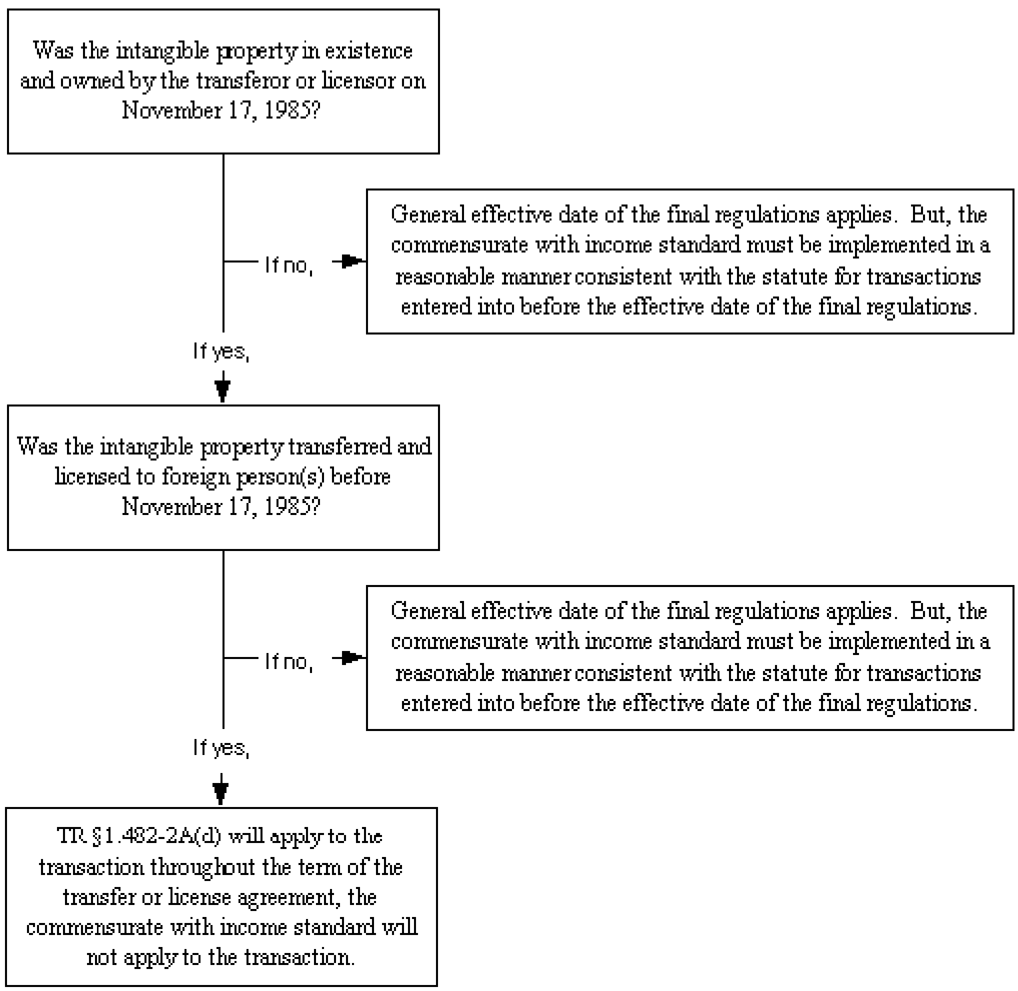
1) In general apply the 1994 regulations, but the 1968 cost sharing regulations still apply.[52]
2) Taxpayer may elect retroactive application for **any open year and all subsequent years**.[53]
3) The taxpayer must comply with the commensurate with income standard for all income years beginning after December 31, 1986, and any method found in the regulations is deemed compliance.[54]
4) Commensurate with income standard does not apply to transfers to foreign persons before November 17, 1985, or to transfers to others before August 17, 1986, **unless** the property subject to the transfer either did not exist or was not owned by the taxpayer at such dates.[55]

5. Income Years Beginning After January 1, 1996

1) The 1996 cost sharing regulations under Treas. Reg. §1.482-7 apply.[56]

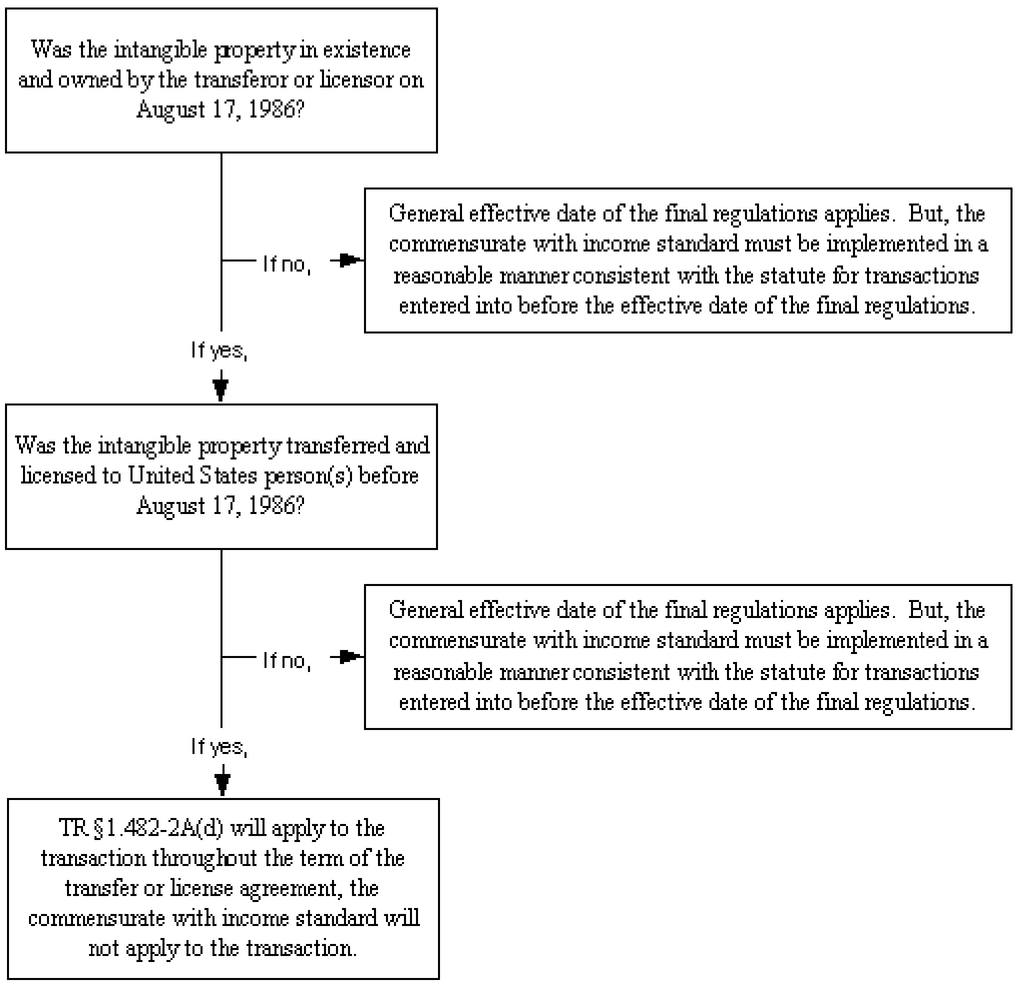
A cost sharing arrangement entered into prior to January 1, 1996 will be considered a qualified cost sharing agreement for purposes of the new regulations if (1) the arrangement was a bona fide cost sharing arrangement under the 1968 regulations (Treas. Reg. §1.482-7T), and (2) the arrangement is amended, if necessary, to conform with the provisions of the new regulations by December 31, 1996.[57]

EFFECTIVE DATES OF THE 1994 FINAL REGULATIONS
CHART 1: OUTBOUND TRANSACTIONS[58]
TRANSFERS OR LICENSES OF INTANGIBLE PROPERTY



EFFECTIVE DATES OF THE 1994 FINAL REGULATIONS
CHART 2: INBOUND TRANSACTIONS[59]

TRANSFERS OR LICENSES OF INTANGIBLE PROPERTY



I. 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 and are discussed in Section 18.6, Water's-Edge Manual:
   a. Comparable Uncontrolled Price Method;
   b. Resale Price Method;
   c. Cost Plus Method;
   d. Comparable Profits Method;
   e. Profit Split Method; and
   f. Unspecified Methods.
6. The 1994 regulations specify the methods that apply for the transfer of intangible property. These include the:
   a. Comparable Uncontrolled Transaction Method;
   b. Comparable Profits Method;
   c. Profit Split Method; and
   d. Unspecified Methods.

This section, in general, discussed the effects of the regulations finalized in 1994, e.g., the best method rule, comparability, the arm's length range, comparison of the regulations and the effective dates. Section 18.6, Water's-Edge Manual will discuss the specific intercompany pricing methods that apply to the transfer of tangible property. The following section, Section 18.7, Water's-Edge Manual will discuss the specific intercompany pricing methods that apply to the transfer of intangible property. And finally, Section 18.8, Water's-Edge Manual will discuss audit considerations when addressing intercompany pricing issues.

Footnotes

1. *Transfer Pricing*, The seventh Annual Institute on Current Issues in International Taxation, by Dora Cheng of Fujitsu America, Inc., and Charles Triplett, Esq., of Mayer, Brown & Platt, dated December 15, 1994. *IRS Final §482 Regulations (TD 8552) For Intercompany Transfer Pricing Issues, July 1, 1994*, full text of regulations in Transfer Pricing, by (BNA) Tax Management Inc., dated July 6, 1994, page 193.
2. Treasury Regulation (Treas. Reg.) §1.482-1(c)(1).
3. Treas. Reg. §1.482-1(c)(2).
4. Treas. Reg. §1.482-1(c)(2)(i).
5. *Finally...Section 482*, Teleconference Handbook, by Internal Revenue Service (IRS) Associate Chief Counsel (International), Associate Commissioner (International and Examination), dated October 27, 1994, page 5.
6. Treas. Reg. §1.482-1(c)(2)(ii)(A).
7. Treas. Reg. §1.482-1(c)(2)(ii)(B).
8. Treas. Reg. §1.482-1(c)(2)(ii)(C).
9. Treas. Reg. §1.482-1(c)(2)(iii).
10. Ibid., note #5.
11. Ibid., note #5.
12. Treas. Reg. §1.482-1(d)(1).
13. Treas. Reg. §1.482-1(d)(2). Ibid., note #5.
14. Treas. Reg. §1.482-1(d)(3)(i).
15. Treas. Reg. §1.482-1(d)(3)(ii)(A).
16. Treas. Reg. §1.482-1(d)(3)(iii)(B)(1).
17. Treas. Reg. §1.482-1(d)(3)(iii)(B)(2).
18. Ibid., note #15.
19. Treas. Reg. §1.482-1(d)(3)(iii)(B).
20. Treas. Reg. §1.482-1(d)(3)(iv).
21. Treas. Reg. §1.482-1(d)(4)(I).
22. Treas. Reg. §1.482-1(d)(4)(I). Ibid., note #5, page 21.
23. Treas. Reg. §1.482-1(d)(4)(ii)(A).
24. Treas. Reg. §1.482-1(d)(4)(ii)(C).
25. Treas. Reg. §1.482-1(d)(4)(iii).
26. Treas. Reg. §1.482-1(e)(1). Ibid., note #5, page 6.
27. Ibid., note #5, page 6.
28. Treas. Reg. §1.482-1(e)(2)(ii).
29. Ibid., note #27.

30. Treas. Reg. §1.482-1(e)(iii)(C).
31. Treas. Reg. §1.482-1(e)(3).
32. Ibid., note #27.
33. Treas. Reg. §1.482-1(f)(2)(iii)(A).
34. Treas. Reg. §1.482-1(f)(2)(iii)(B).
35. Ibid., note #34.
36. Treas. Reg. §1.482-1(h)(2). Ibid., note #27.
37. Treas. Reg. §1.482-1(h)(2)(iii). Ibid., note #5, page 7.
38. Revenue and Taxation Code §25114(b)(3).
39. Ibid., note #5, page 10-13.
40. Ibid., note #39.
41. Ibid., note #39.
42. Treas. Reg. §1.482-1(j). Ibid., note #5, page 8.
43. Treas. Reg. §1.482-1T(h).
44. Ibid., note #42.
45. Treas. Reg. §1.482-1(j)(3).
46. Ibid., note #43.
47. Ibid., note #45.
48. Treas. Reg. §1.482-1(j)(4).
49. Ibid., note #43. Treas. Reg. §1.482-1(j)(1).
50. Ibid., note #45.
51. Ibid., note #48.
52. Treas. Reg. §1.482-1(j)(1).
53. Treas. Reg. §1.482-1(j)(2).
54. Ibid., note #45.
55. Ibid., note #48.
56. Treas. Reg. §1.482-7(k)
57. Treas. Reg. §1.482-7(l)
58. Ibid., note #48.
59. Ibid., note #48.

Section 18.6 Intercompany Transfer Pricing Transfer Of Tangible Property – Determination Of An Arm's Length Price

Contents:

a. Introduction
b. Overview Of The Regulations
c. Comparable Uncontrolled Price Method
   1. In General
   2. Pre-1994 Regulations
   3. Post-1994 Regulations
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   1. Pre-1994 Regulations
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e. Cost Plus Method
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f. Comparable Profits Method
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   2. Determination of an Arm's-Length Result
   3. Tested Party
   4. Arm's-Length Range
   5. Profit Level Indicators
g. Profit Split Method
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   2. Comparable Profit Split Method
   3. Residual Profit Split Method
h. Unspecified Methods
i. Coordination With Intangible Property Rules
j. Summary

References:

Revenue and Taxation Code §24725
Revenue and Taxation Code §25114
California Code of Regulations §25114

Internal Revenue Code §482
Treasury Regulations §1.482-1
Treasury Regulations §1.482-2A(e)
Treasury Regulations §1.482-3
Treasury Regulations §1.482-5
Treasury Regulations §1.482-6

Training Objectives:

This section discusses the intercompany pricing methods for the transfer of tangible property. By the end of §18.6, you will be able to identify the six pricing methods and understand the primary characteristics of each.

a. Introduction

The Treasury Regulations (TR) pursuant to Internal Revenue Code (IRC) §482 discuss in some detail the methods to be employed in arriving at an arm's length price for a variety of intercompany transactions: loans, services, the use of tangible property and the transfer of tangible and intangible products. 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. TR §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. TR §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. TR §1.482-5 specifically explains the comparable profits method, while TR §1.482-6 explains the profit split method. The six methods will be discussed in this section, however, realize that the comparable profits and profit split methods apply to the transfer of both tangible and intangible property.

TR §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 TR §1.482-1, TR §1.482-3, TR §1.482-5 and TR §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:
1. Comparable Uncontrolled Price (CUP) Method;
2. Resale Price Method;
3. Cost Plus Method;
4. Comparable Profits Method;
5. Profit Split Method; and
6. 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.

The 1968 regulations, re-numbered to TR §1.482-2A(e)(1), stated that allocations could be made between the seller of tangible property and the buyer to reflect an arm's length price for that sale. The arm's length price was defined as the price an unrelated party would have paid under the same or similar circumstances for similar property. Any allocation made by the government would reflect the differences determined by the comparison of a controlled sale to an independent sale.

The 1968 regulations contained the first three methods listed above and what was known as the "fourth" method or "other" category, which was applied only when the first three methods could not be applied. TR §1.482-2A(e)(1)(ii) and (iii) allowed the use of a fourth method described generally as "some appropriate method of pricing". The 1968 regulations applicable to the transfer of tangible property have been re-numbered to TR §1.482-1A and TR §1.482-2A.

TR §1.482-2A(e)(1)(iv) allowed the appropriate pricing methods to be applied along product lines or groupings, or the use sampling methods where useful. This gave some flexibility to auditors, particularly in situations where the taxpayer had a pricing problem in some products and could argue that while admittedly there was a problem with the product, there should be no adjustment if the taxpayer was "making up for it in another product". This is not a viable argument unless the taxpayer can prove that there was a distortion in his favor due to a non-arm's length transaction concerning another product or transaction. If this were the case, there could be a set-off adjustment, but only after the taxpayer has proven their position.[1] This concept remains in the 1994 finalized regulations as TR §1.482-1(f)(2)(iv).

Pursuant to the 1968 regulations for the various methods, the circumstances of the uncontrolled sale had to be significantly equal to the circumstances of the controlled sale. Also, only minor adjustments could be made to the comparables. In general, finding these significantly equal comparables was either difficult or impossible. The regulations finalized in 1994 allow the use of inexact comparables within all the pricing methods.

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:

1. Sales by a member of the controlled group to unrelated parties;
2. Sales in which the parties are not members of the controlled group and are also not related to each other; or
3. 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. However, TR §1.482-2A(e)(1)(v) requires the price of ores or mineral products be determined under the provisions of TR §1.613-3 and TR §1.613-4. It is not appropriate, for purposes of the CUP method, to make comparisons of property involving an intangible, such as a trademark, since the effect of the trademark on the price is not reasonably ascertainable .

2. Pre-1994 Regulations

Prior to the 1994 regulations, uncontrolled sales were considered comparable to controlled sales if the physical property and the circumstances of such sales were identical or were so nearly identical that any difference:
Either had no effect on the price; or
Could be reflected by a reasonable number of adjustments.

Reasonable adjustments for this method included adjustments for differences in the:

1. Terms of sale;
2. Quantities traded;
3. Physical differences in the product;
4. Level of market (e.g., manufacturer, distributor, wholesaler, retailer or customer); and
5. Geographical markets.

No exhaustive list of these adjustments were provided in the regulations. What would constitute an appropriate adjustment under one method would not necessarily constitute an appropriate adjustment under another method. The rule for making adjustments under the CUP method was that the adjustments were few, simple and specific. Every example in the regulations demonstrated this. That is, examples used items such as warranty charges, delivery charges and charges for minor modifications. These are specific terms that the buyer usually knows at the point of sale and the price would take them into account.

To go even farther, TR §1.482-2A(e)(2)(iii) states that if there is one uncontrolled sale with an adjustment for a delivery charge, and another uncontrolled sale with adjustments for a delivery charge and a finance charge, the uncontrolled sale with only the delivery charge adjustment should be used for comparison with the controlled sales. The purpose of controlling the adjustment types was to simplify what was already a difficult process, and to prevent the injection of uncertain adjustments into the price.

To use the CUP method pursuant to the 1968 regulations, a comparison of the circumstances of the sales needed to be made. Therefore, a functional analysis would be performed to determine any differences in the level of market, services performed between the buyer and seller, etc. If the impact of such differences was reasonably measurable, the uncontrolled price was adjusted to arrive at the arm's length price. If the CUP method could not be used because of the facts and circumstances, the next method to consider was the resale price method. Recall that the 1968 regulations contained the hierarchy of methods where the CUP method was given first priority. The CUP method had to first be applied to the tested transaction. If the CUP method was not usable, the next method, the resale price method, had to be applied.

3. Post-1994 Regulations

For purposes of determining whether or not the result of applying the CUP method is the most reliable measure of an arm's length result, the best method rule must be applied. The best method rule was discussed in Section 18.5(c), Water's-Edge Manual. 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[2]) 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[3]) in the analysis.[4]

Tangible property and circumstances of the controlled and uncontrolled transactions must be substantially similar.[5] 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.

Specific examples of the factors that are relevant to the CUP method include:

1. Quality of product;
2. Contractual terms (e.g., scope and terms of warranties, sale or purchase volume, credit terms and transport terms);
3. Level of the market (e.g., manufacturer, distributor, wholesaler, retailer or customer);
4. Geographical market in which the transaction takes place;
5. Date of transaction;
6. Intangible property associated with the sale;
7. Foreign currency risks; and
8. Alternatives realistically available to the buyer and the seller.[6]

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.[7]

d. Resale Price Method

1. Pre-1994 Regulations

TR §1.482-2A(e)(3)(ii) states that certain circumstances must exist before the resale price method can be used:

1. There must be no comparable uncontrolled sales with respect to a CUP method application;
2. An applicable resale price must be available with respect to resales made within a reasonable time before or after the controlled sale;
3. The reseller cannot add more than an insubstantial amount to the value of the property by physically altering the product before resale (packaging, labeling or minor assembly of property does not constitute physical alteration); and
4. The reseller must not add more than an insubstantial amount of value to the property by the use of its intangible property.

There was an exception to these circumstances that generally provided that even though the requirements of (3) and (4) above were not satisfied, the resale price method could still be used if it was more feasible and likely to result in a more accurate determination of an arm's length price than if the cost plus method were applied.[8]

Under the resale price method, the arm's length price of a controlled sale is equal to the applicable resale price less an appropriate mark-up, and is adjusted as provided in the regulations. In contrast to the CUP method, this method then makes allocations based on a comparison of the gross profit ratio realized in the controlled sale versus the average gross profit ratios of comparable uncontrolled resellers.

An appropriate mark-up is computed by multiplying the applicable resale price by the appropriate mark-up percentage. Thus, where one member of a group of controlled entities sells property to another member, which resells the property in uncontrolled sales, if the applicable resale price of the property involved in the uncontrolled sale is $100 and the appropriate mark-up percentage for resales by the buyer is 20 percent, then the arm's length price of the controlled sale is $80 [$100-$20(20%X$100)=$80].

When making the determination as to the similarity of resale transactions, the following characteristics had to be considered:

1. The type of property involved in the sales. Categories such as machine tools, men's furnishings, or small household appliances can be used;
2. The functions performed by the reseller with respect to the property, e.g., advertising, packaging, minor assembly, servicing, maintenance of a dealer network and delivery;
3. The effect on price of any intangible, e.g., patents, trademarks and trade names, used by the reseller in connection with the property; and
4. The geographic market in which the functions were performed by the reseller.

The resale price method applies gross profit margin data from uncontrolled comparables to a controlled transaction by deducting an appropriate gross margin from the selling price. In reality, uncontrolled comparables generally do not reflect margins that an unrelated party receives in the sale of the same specific product. Instead, uncontrolled comparables typically reflect the gross margins received from a mix of different products. Thus, the resale price method does not require the collection of detailed, product-specific data, although such data may often have a significant bearing on the degree of comparability between a controlled and uncontrolled transaction.

This method focuses only on one side of the bargaining process because it uses the gross margin of an arm's length reseller to establish the gross margin to be used in setting intercompany prices. The related reseller should realize a comparable gross margin as that of the uncontrolled reseller. However, the gross margin and interests of intercompany manufacturers are not taken into account. Thus, the company selling to the related reseller may realize gross and/or operating margins that are substantially higher, or lower, than those realized by the company selling to the independent reseller.[9]

Note that when reviewing these characteristics, in general it is the distribution functions being evaluated. The resale price method is typically used when the tested party is a distributor. In addition, the goods in uncontrolled sales used for comparison purposes need not have a close physical similarity to the tested goods, although it is advisable to use comparable parties selling as similar property as possible, or at least in a similar industry. However, a situation may arise where the particular industry in which the taxpayer is involved is controlled by either a monopoly or an oligopoly. Thus, the companies controlling the market all have controlled transactions. If this is the case, the choice of comparables is extremely restricted and other similar industries may have to be reviewed to find comparable independent sales.

Because of the variables involved, this method is not as accurate as the CUP method. It is really only an estimate of the price. Therefore, it is a good idea to test the resale price method with other financial ratios in addition to the gross profit ratio.

2. Post-1994 Regulations

The calculations within the resale price method itself have not changed. The method remains particularly dependent on similarities of functions performed, risks borne and contractual terms. 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.[10]

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.[11]

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. The best method rule was discussed in §18.5, on page 18.5 - 4, §c, *Best Method Rule*. 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[12]) 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[13]) in the analysis.[14]

For purposes of comparing controlled and uncontrolled transactions, the following factors are relevant to the resale price method. These include:

1. Inventory levels, turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;
2. Contractual terms (e.g., scope and terms of warranties, sale or purchase volume, credit terms and transport terms);
3. Sales, marketing, advertising programs and services, including promotional programs, rebates and co-operative advertising;
4. Level of the market (e.g., manufacturer, distributor, wholesaler, retailer or customer); and
5. Foreign currency risks.[15]

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

1. Pre-1994 Regulations

If neither the CUP nor the resale price methods could be applied, TR §1.482-2A(e)(4) then allowed the application of the cost plus method. Unlike the previous methods, the starting point in the cost plus method is the *cost* of the tangible property sold in the controlled transaction. A reasonable mark-up is added to the cost of producing the tangible property. The mark-up applied is the value equal to the gross profit on sales to the sales price earned by the seller or other sellers on uncontrolled sales of similar property.

For example, where one member of a group of controlled entities manufactures property and sells it to another member of the group, if the appropriate mark-up percentage of similar property involved in an uncontrolled sale is 38 percent and the applicable costs to manufacture the property is $125, then the arm's length price of the controlled sale of the manufactured property is $173 [$125 X 138%(100% of costs plus 38% mark-up)].

Under the cost plus method, the arm's length price is determined by adding:

1. The cost of producing the tangible property; plus
2. An amount which is the cost multiplied by an appropriate gross profit percentage; plus or minus
3. Certain adjustments.

This method is generally used when a manufacturer sells its product to a related party or when a related buyer adds value to the product it has purchased from a related party. Thus, the cost plus method is typically used when transactions involve the manufacture, assembly or other production of tangible property that is sold to related parties.

There is somewhat of a similarity between this method and the resale price method, in that the standard of comparison is the gross profit earned by an independent seller in an uncontrolled sale. Adjustments must be made to the gross margins earned by the independent manufacturers/sellers for differences in functions performed, such as intangibles used in connection with the manufacture of the property, e.g., patents, and other factors. Again the comparable property does not have to be physically identical but there should be enough similarity in the product type and the manufacturing process to make the independent transaction as similar as possible to the controlled transaction.

Because of the variables involved, the cost plus method is not as accurate as the CUP method or the resale price method, and is much more difficult to use. Not only must the separate cost elements of production be identified, the costs such as research and development, overhead costs and management costs must be allocated to the various product lines, for both the controlled manufacturer and for the chosen comparable uncontrolled manufacturer. In addition, not only must the differences in the intangibles, such as the manufacturing patents, be accounted for, adjustments for functional differences in the manufacturing process must also be considered. It is a good idea to test the cost plus method with other financial ratios in addition to the gross profit ratio.

Close physical similarity between the products is not required. However, the products should preferably be within the same product category.[16] The cost plus method applies gross profit margin data from uncontrolled comparables to a controlled transaction by adding the gross mark-up to the cost of sales. Like the resale price method, the cost plus method relies upon the gross margins realized by unrelated parties.

Thus, the cost plus method does not require the collection of detailed, product-specific data on uncontrolled comparables, though such data often may have a significant bearing on the degree of comparability between a controlled and uncontrolled transaction. Again, like the resale price method, the cost plus method focuses on only one side of the bargaining process. By applying the gross cost plus mark-up reported by an unrelated supplier to transactions among related parties, the cost plus method does not ensure that the intercompany purchaser has parity with an independent purchaser.[17]

2. Post-1994 Regulations

The calculations within the cost plus method itself have not changed. The method remains particularly dependent on similarities of functions performed, risks borne and contractual terms. 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. Again, 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.[18]

For purposes of determining whether or not the result of applying the cost plus method is the most reliable measure of an arm's length result, the best method rule must be applied. The best method rule was discussed in Section 18.5(c), Water's-Edge Manual. 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[19]) 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[20]) in the analysis.[21]

For purposes of comparing controlled and uncontrolled transactions, the following factors are relevant to the cost plus method. These include the:

1. Complexity of manufacturing or assembly;
2. Manufacturing, production and process engineering;
3. Procurement, purchasing and inventory control activities;
4. Testing functions;
5. Selling, general and administrative expenses;
6. Foreign currency risks; and
7. Contractual terms (e.g., scope and terms of warranties, sale or purchase volume, credit terms and transport terms).[22]

Again, 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.[23] 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.[24]

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[25]) 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[26]) in the analysis,[27] must be 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:

1. Lines of business;
2. Product or service markets involved;
3. Asset composition employed, including the nature and quantity of tangible assets, intangible assets and working capital;
4. Size and scope of the operations; and
5. 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.[28] Rather than product comparability, what is relevant is functional comparability.

As with all methods, adjustments are made for the differences that would materially effect 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:

1. Selling, general and administrative expenses;
2. Research and development expenses;
3. Carrying costs of inventory;
4. Time value of accounts payable granted by suppliers; and
5. Carrying costs of accounts receivable extended to customers.[29]

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.[30]

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.[31] The tested party's operating profit must first be adjusted to reflect all other allocations pursuant to IRC §482.[32]

4. Arm's Length Range

The arm's length range is established by using comparable operating profits derived from a single profit level indicator.[33]

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.[34] 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:

1. Nature of the activities of the tested party;
2. Reliability of the available data with respect to uncontrolled comparables; and
3. 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 TR §1.482-1. Multiple year analysis was discussed in Section 18.5(g), Water's-Edge Manual.

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

1. Rate of return on capital employed;
2. Financial ratios, including the ratio of operating profit to sales and the ratio of gross profit to operating expenses; and
3. Other profit level indicators.[35]

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.[36]

TR §1.482-5(d) provides definitions of the financial ratios to apply, while TR §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.[37]

A profit split method is a three-step process where the following is performed:

1. Determine the combined profit of commonly controlled parties from activities relating to the transactions between the two parties;
2. Split the combined profit between the two parties based on some formulary basis; and
3. Derive transfer prices for transactions between the two parties consistent with the formulary allocation of profits.[38]

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 TR §1.482-1(d)(3).[39] That is, consider the degree of comparability, i.e., functions performed, contractual terms, risks borne, economic conditions and any items of property provided or services performed.[40]

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 income 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.[41]

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.

The specific method of allocation must be determined applying one of two profit split methods, the:

1. Comparable profit split method; or
2. Residual profit split method.[42]

Thus, 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.

TR §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.[43]

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. The best method rule was discussed in Section 18.5(c), Water's-Edge Manual. 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[44]) 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[45]) in the analysis.[46]

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:

1. Lines of business;
2. Product or service markets involved;
3. Asset composition employed, including the nature and quantity of tangible assets, intangible assets and working capital;
4. Size and scope of the operations; and
5. 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.[47] What is relevant is functional comparability, not product comparability.

For purposes of evaluating data and assumptions within the best method rule, the following must be considered:

- 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:

1. Allocate income to routine contributions; and
2. 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 this section, §18.6.

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.[48]

For purposes of 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[49]) 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[50]) in the analysis,[51] must be applied.

For purposes of evaluating data and assumptions within the best method rule, the following must be considered:

1. The reliability of the allocation between the relevant business activity and the participant's other activities of the costs, income and assets;
2. 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
3. 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. This "other" category was known as the fourth method with respect to the 1968 regulations.

Unspecified methods, or the fourth method with respect to the 1968 regulations, may be used to evaluate whether the amount charged in a controlled transaction is arm's length. However, any unspecified method that is used must apply the general principles of TR §1.482-1, e.g., the 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.[52]

For 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.[53] 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.

In the past, the fourth method usually arrived at an arm's length price by making a profit split computation, or by comparing certain financial ratios of the taxpayer to the same ratios of an unrelated entity. In this instance, typically no one ratio was considered sufficient and a decision was commonly made by reviewing at least three or four ratios such as a return on assets, gross profit ratio, return on capital employed, the berry ratio or the ratio of operating income to operating expenses.

If an unspecified method is being applied, it is advisable to use more that one form of financial analysis. For example, in the <u>E.I. Dupont de Nemours and Company</u>[54] case, the Internal Revenue Service (IRS) determined an arm's length price by using a 50-50 profit split approach and was able to convince the court that this approach was reasonable. The expert witnesses used by the IRS were Dr. Charles Berry and Dr. Irv Plotkin.

Dr. Berry 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, he 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.

Dr. Plotkin also determined that the results of the profit split were reasonable because of the return on asset ratios for similar industries. Both Dr. Berry's and Dr. Plotkin's methods have been used extensively when the fourth method is applied.

Finally, the taxpayer should disclose the use of an unspecified method on its timely filed return.[55]

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.[56] 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 will be determined under the principles described in Section 18.7, Water's-Edge Manual. 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. For income years beginning on or before April 21, 1993, TR §1.482-2A contains the allowable methods used to determine an arm's length price for the transfer of tangible property. The three specified methods are the: CUP method, resale price method and cost plus method. These methods had to be applied strictly in that order. If the specified methods could not be applied, a fourth method, or other method, could be used.
2. For income years beginning before October 6, 1994, and after April 21, 1993, the 1993 temporary regulations apply, while the 1968 cost sharing regulations continue to apply. The temporary regulations contained six allowable methods to use 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 (proposed only) and other methods. These methods no longer are required to be applied in a strict order.
3. For income years beginning after October 6, 1994, TR §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. The taxpayer can retroactively apply these methods to any open income year.
4. The determination of which method is the most reliable to apply is based on the best method rule finalized in the 1994 regulations. 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.
5. 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. With respect to the 1968 regulations, the arm's length price under the CUP method is the price of similar uncontrolled items, plus or minus limited adjustments. Applying the 1994 regulations, the arm's length price under the CUP method is the price of similar uncontrolled items, plus or minus any needed adjustments for material differences.
6. 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.

7. 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 product comparability, what is relevant is functional comparability.
8. 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. TR §1.482-6 provides two separate profit split methods, the comparable profit split method and the residual profit split method.
9. 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. What is relevant for purposes of comparability is the functions performed, not product comparability.
10. 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.
11. 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.

This section discussed the six methods to be applied when determining the intercompany transfer price for the transfer of tangible property. Section 18.7, Water's-Edge Manual will discuss the four methods to be applied when determining the intercompany transfer price for the transfer of intangible property.

Footnotes

1. Treasury Regulations (TR) §1.482-1(d)(3).
2. TR §1.482-1(d)(1).
3. *Finally...Section 482*, Teleconference Handbook, by Internal Revenue Service (IRS) Associate Chief Counsel (International), Associate Commissioner (International and Examination), dated October 27, 1994, page 5.
4. TR §1.482-3(b)(2)(i).
5. TR §1.482-3(b)(2)(ii).
6. TR §1.482-3(b)(2)(ii)(B).
7. *Guide To Transfer Pricing Compliance*, by Charles Triplett, Esq., dated August 1994, 310, page 17.
8. TR §1.482-2A(e)(3)(iii).
9. Ibid., note #7, 320.
10. TR §1.482-3(c)(1).
11. TR §1.482-3(c)(2).
12. Ibid., note #2.
13. Ibid., note #3.
14. TR §1.482-3(c)(3)(i).
15. TR §1.482-3(c)(3)(ii)(C).
16. TR §1.482-3(d)(3)(ii)(B).
17. Ibid., note #7, 330, page 59.
18. TR §1.482-3(d)(3)(A).
19. Ibid., note #2.
20. Ibid., note #3.
21. Ibid., note #4.
22. Ibid., note #15.
23. TR §1.482-5(a).
24. Ibid., note #7, 501, page 10.
25. Ibid., note #2.
26. Ibid., note #3.
27. Ibid., note #4.
28. TR §1.482-5(c)(2)(iii).
29. Ibid., note #7, 523, page 29.
30. TR §1.482-5(b)(1).
31. Ibid., note #4.
32. Ibid., note #5.
33. TR §1.482-5(b)(3).

34. Ibid., note #33.
35. TR §1.482-5(b)(4).
36. TR §1.482-5(b)(4)(iii).
37. TR §1.482-6(a).
38. Ibid., note #7, 601, page 7.
39. TR §1.482-6(b).
40. Ibid., note #2.
41. Ibid., note #39.
42. TR §1.482-6(c)(1).
43. TR §1.482-6(c)(2)(B)(1).
44. Ibid., note #2.
45. Ibid., note #3.
46. Ibid., note #4.
47. Ibid., note #28.
48. TR §1.482-6(c)(3)(i)(B).
49. Ibid., note #2.
50. Ibid., note #3.
51. Ibid., note #4.
52. TR §1.482-3(e)(1).
53. TR §1.482-3(e)(2).
54. E.I. Dupont de Nemours and Company v. United States, 608 F2d 445 (Ct. Cl. 1979), adopt'd in part 78-1 USTC 9374 (Ct. Cl. Tr. Div. 1978).
55. TR §1.482-3(e). TR §1.482-4(d). TR §1.6662-6T.
56. TR §1.482-1(d)(3)(v).

Section 18.7 Transfer Of Intangible Property Determination Of An Arm's Length Price

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References:

Revenue and Taxation Code §24725
Revenue and Taxation Code §25114
California Code of Regulations §25114
Internal Revenue Code §482
Treasury Regulations §1.482-1
Treasury Regulations §1.482-4

Treasury Regulations §1.482-5
Treasury Regulations §1.482-6
Treasury Regulations §1.482-7

Training Objectives:

This section discusses the intercompany transfer pricing methods for the transfer of intangible property. By the end of §18.7, you will be able to identify the four pricing methods and the cost sharing rules, and understand the primary characteristics of each.

a. Introduction

The Treasury Regulations pursuant to Internal Revenue Code (IRC) §482 discuss in some detail the methods to be employed in arriving at an arm's length price for a variety of intercompany transactions: loans, services, the use of tangible property and the transfer of tangible and intangible products. This section deals with the determination of an arm's length price when intangible property is transferred between related parties.

Auditing intercompany transactions that involve an intangible asset is the most difficult IRC §482 issue because of the difficulty in finding comparable intangible transactions. Treas. Reg. §1.482-4 contains many examples demonstrating these concepts that are not included in this section. Should you pursue an intercompany pricing issue related to the transfer of intangible property, review Treas. Reg. §1.482-1, §1.482-4, §1.482-5 and §1.482-6.

b. Overview Of The Regulations

1. Pre-1994 Regulations

The 1968 regulations, re-numbered to Treas. Reg. §1.482-2A(d)(1), state that where intangible property or an interest therein is transferred, sold, assigned, loaned or otherwise made available in any manner by one member of a controlled group to another member of the controlled group for other than an arm's length consideration, allocations may be made pursuant to IRC §482 to reflect an arm's length consideration for such property or its use. Any allocation made would reflect the differences determined by the comparison of a controlled transaction to an independent transaction.

The arm's length consideration must be in a form which is consistent with the form which would have been adopted in transactions between unrelated parties under the same or similar circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms:

1. Royalties based on the transferee's output, sales, profits or any other measure;
2. Lump-sum payments; or
3. Any other form, including recipient licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them.

However, where the transferee pays nominal or no consideration for the property or interest therein and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.[1]

In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfer must generally be the best indication of an arm's length consideration.[2]

Where a sufficiently similar transaction involving an unrelated party cannot be found, several factors were listed to consider to arrive at an arm's length consideration. Among the list of thirteen items is the prevailing rates in the same industry, offers or bids of competing transfers, the terms of the transfer and the uniqueness of the property.[3]

Pursuant to IRC §482, where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, an allocation with respect to such acquisition is not required, except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a controlled group providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced.

In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of developing an arm's length basis. In order for the sharing of costs and risks to be considered an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an agreement.[4]

Pursuant to the 1968 regulations, the circumstances of the uncontrolled transaction had to be significantly equal to the circumstances of the controlled transaction. Also, only minor adjustments could be made to the comparables. In general, finding these significantly equal comparables was either difficult or impossible. The 1968 regulations applicable to the transfer of intangible property have been re-numbered to Treas. Reg. §1.482-1A and §1.482-2A.

2. Post 1994 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 1994 regulations provide more guidance with respect to the transfer of intangible assets than did the 1968 regulations. The 1968 regulations did not contain these specific methods. The four methods that can be used to determine the arm's length price for the transfer of intangible property include the:

1. Comparable Uncontrolled Transaction (CUT) Method;
2. Comparable Profits Method;
3. Profit Split Method; and
4. 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. These methods were discussed in Section 18.6(f), Water's-Edge Manual and Section 18.6(g), Water's-Edge Manual. 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. Unspecified methods were discussed in Section 18.6(h), Water's-Edge Manual. The remaining method to be discussed, the comparable uncontrolled transaction method, will be 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.[5]

3. 1996 Cost Sharing Regulations

New cost sharing regulations were finalized as Treas. Reg. §1.482-7, effective for income years beginning on or after January 1, 1996. The 1968 regulations had contained a single paragraph which allowed controlled entities to enter into agreements to share the costs of developing intangible property, but the new 1996 rules are much more comprehensive. The new cost sharing rules are discussed in Section 18.7(f), Water's-Edge Manual.

c. Intangible Property Defined

The regulations contain 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:

1. Patents, inventions, formulae, processes, designs, patterns or know-how;
2. Copyrights and literary, musical or artistic compositions;
3. Trademarks, trade names or brand names;
4. Franchises, licenses or contracts;
5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
6. Other items, if its value is derived from its intellectual content or any other intangible properties, rather than from its physical attributes.[6]

d. 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 was not specifically identified in the 1968 regulations, but became formalized in the 1994 regulations.

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.[7] For purposes of 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 best method rule was discussed in Section 18.5(c), Water's-Edge Manual. 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)[8] 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)[9] in the analysis.[10]

The intangible property and circumstances of the controlled and uncontrolled transactions must be the same or substantially the same.[11] 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.[12]

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

1. Be used in connection with similar products or processes within the same general industry or market; and
2. Have similar profit potential.[13]

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.[14]

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, comparison of profit potential may be based upon these factors:[15]

1. 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;
2. 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;
3. Rights to receive updates, revisions or modifications of the intangibles;
4. 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;
5. The duration of the license, contract or other agreement, and any termination or renegotiation rights;
6. Any economic and product liability risks to be assumed by the transferee;
7. The existence and extent of any collateral transactions or ongoing business relationships between the transferee and the transferor; and
8. The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

The arm's length range, discussed in Section 18.5(f), Water's-Edge Manual, must also be determined for this method. No additional guidance is provided with respect to the arm's length range and intangible property. 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.

e. 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.[16] 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 to the consideration in a subsequent income year.[17]

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

1. Both the controlled transaction and the uncontrolled comparable involve the same intangible;
2. 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;[18]
3. 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;[19]
4. 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; or
5. 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.[20]

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.[21] 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.[22]

In addition, an intangible asset may have multiple legal owners.[23] 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.[24]

3. Coordination With IRC §936

Pursuant to IRC §936(h)(5), taxpayers with a significant business presence in Puerto Rico or another United States possession may elect to compute their possessions source trade or business income subject to the cost sharing method of IRC §936(h)(5)(C)(i). Under the cost sharing method, the possessions corporation must make a payment of at least 110 percent of research expenses incurred by its affiliated group for the product area covered by the election multiplied by the proportion of total affiliated group sales represented by possessions sales. If the cost sharing election is made, the possessions corporation will be treated as owning and entitled to a return on, patents and other manufacturing intangibles. However, it generally will not be entitled to a return on marketing intangibles.

Alternatively, a corporation with a significant business presence in Puerto Rico or another United States possession may elect the profit split method of IRC §936 (h)(5)(C)(ii). Under the profit split method, the possessions corporation is entitled to report on its own return, and to receive the IRC §936 credit for taxes with respect to, 50 percent of combined taxable income earned by it and its United States affiliates from products or services covered by the election.

If a possessions corporation makes an election under IRC §936(h), the corporation must make an IRC §936 cost sharing payment that is at least equal to the payment that would be required under arm's length standards.[25] Until the appropriate cost sharing payment is made, the possessions corporation is not treated as owning or entitled to a return on the manufacturing intangibles which it otherwise would be entitled to report on a return under the IRC §936(h)(5) cost sharing method.[26]

4. 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.[27]

5. 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.[28]

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.

f. Cost Sharing Arrangements

1. In General

Cost sharing arrangements may be entered into by taxpayers as an alternative to the general §482 rules in situations where one or more members of a controlled group develops an intangible that is used by other members of the group. 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 §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.[29]

2. Qualified Cost Sharing Arrangements

In order to be a qualified cost sharing arrangement, an arrangement must include the following elements:[30]

1. There must be two or more participants;
2. A method must be provided to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;

3. There must be a provision for adjustments to be made to the controlled participant's share of the intangible development costs to account for changing circumstances; and
4. The agreement must be recorded in a document that is contemporaneous with the formation or revision of the cost sharing arrangement. The Regulations specify the information that is required to be included in the document (Treas. Reg. §1.482-7(b)(4)). The required information includes a description of the scope of the research and development to be undertaken, the intangible or class of intangibles to be developed, and a description of each participant's interest in any covered intangibles. This document is important because it defines the scope of the "intangible development area." The cost sharing rules will not apply to projects that are not covered by the agreement.

3. Controlled Participants

A controlled corporation will only be considered a controlled participant in a qualified cost sharing arrangement if it reasonably anticipates that it will derive benefits from the intangibles covered by the arrangement, and if it substantially complies with accounting and administrative requirements in the Regulation.[31] If a controlled corporation does not meet the criteria to be a controlled participant (e.g., if it will not derive benefits from the intangible) but provides assistance relating to the research and development of the intangible, then it must receive arms-length payment for the assistance that it provides. Payments to a non-participant will be treated as an operating expense related to development of the intangible, and will be shared among the participants along with the other development costs.[32] Uncontrolled corporations may also be a party to a cost sharing agreement, but the rules regarding allocation of costs in proportion to the reasonably anticipated benefits will only apply to the controlled participants (Example 5 covers a situation with an uncontrolled participant).

Example 1:

PharmChemic, Inc., a domestic corporation, and its foreign subsidiaries Gelcap Ltd. and Biolab Ltd. are conducting research to develop new cancer treatments. PharmChemic is assigned the exclusive right to produce and market the new treatments in the U.S., and Gelcap is assigned the exclusive right to produce and market the treatment in Europe. Biolab's role is to provide research services to the other members of the controlled group, but it is not assigned any rights to exploit the technology that is developed. PharmChemic and Gelcap enter into a cost sharing agreement with respect to the development process, and project that they will receive 60% and 40%, respectively, of the reasonably anticipated benefits from the technology.

Because Biolab will not derive any benefits from the use of the covered intangibles, it does not qualify as a controlled participant. Therefore, Biolab is treated as a service provider and must receive arm's-length consideration for the assistance that it provides to PharmChemic and Gelcap. Those payments will be treated as intangible development costs incurred by PharmChemic and Gelcap in proportion to their shares of the reasonably anticipated benefits (i.e., 60% and 40% respectively).

For purposes of the cost sharing rules, members of an affiliated group that join in the filing of a consolidated return will be treated as one taxpayer.[33] California's conformity to §482 includes this requirement, so auditors should look to the consolidated return rather than the combined report in order to apply this rule.

Example 2:

Mega Co. and Science Co. are members of a federal consolidated return. Science Co. is an R&D company which develops new products for manufacture and sale by Mega Co. and its foreign affiliates. On a separate company basis, Science Co. would not qualify as a controlled participant in a cost sharing arrangement because it will not share in the benefits from the intangibles that are developed. When treated as a single taxpayer however, the Mega/Science Co. unit is expected to derive benefits from Mega Co.'s exploitation of the intangibles, and therefore will qualify as a controlled participant for purposes of a cost sharing arrangement.

4. Intangible Development Costs

Costs related to developing intangibles under a cost sharing agreement include the following items:[34]

1. Operating expenses as defined in Treas. Reg. §1.482-5(d)(3), other than depreciation or amortization expense;

2. Charges for the use of any tangible property made available to the qualified cost sharing arrangement. (If the property is made available by a controlled participant, the appropriate charge will be governed by the rules of Treas. Reg. §1.482-2(c).)

Note: Intangible development costs *do not* include consideration for the use of *intangible* property in the development process. If a controlled participant makes pre-existing intangible property available for use in the development of an intangible covered by the cost sharing agreement, then the other controlled participants must each make a "buy-in" payment to the owner of the intangible. The amount of the buy-in payment for each controlled participant is the arm's-length charge for the use of the intangible under the rules of Treas. Reg. §1.482-1 and §1.482-4 through -6, multiplied by that controlled participant's share of the reasonably anticipated benefits from the cost sharing arrangement. Such payments will be treated as consideration for an interest in the pre-existing intangible property.[35]

If a particular cost relates to both the development of an intangible and to other business activities, then the cost must be allocated as provided in the regulation.[36]

5. Reasonably Anticipated Benefits

For purposes of the cost sharing rules, "reasonably anticipated benefits" are the aggregate benefits that a controlled particpant reasonably anticipates it will derive from the intangibles covered by the cost sharing agreement. Benefits may either be additional income generated by use of the covered intangibles, or costs saved by the use of covered intangibles.[37]

A controlled participant's share of reasonably anticipated benefits from covered intangibles will be determined using the most reliable estimate. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account. The reliability of the basis used for measuring the benefits and the projections used to estimate the benefits are particularly relevant.[38]

The amount of benefits that each controlled participant is reasonably anticipated to derive from the covered intangible must be measured on a basis that is consistent for all such participants. The most reliable basis for measuring reasonably anticipated benefits should be used, whether that basis is direct or indirect. A direct basis for measurement is by reference to estimated additional income to be generated or costs to be saved by the use of covered intangibles. An indirect basis is by reference to certain measurements that reasonably can be assumed to be related to income generated or costs saved. Indirect bases for measuring anticipated benefits may include the following:

1. Units used, produced or sold. Units of items used, produced or sold by each controlled participant in the business activities in which the covered intangibles are used may be used as an indirect basis for measuring anticipated benefits. This method will be more reliable when the per-unit increase in net profit attributable to the covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when the covered intangibles are exploited by the controlled participants in the use, production or sale of substantially uniform items under similar economic conditions.
2. Sales. Sales will be a more reliable basis of measurement when the increase in net profit per dollar of sales attributable to the covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when the costs of exploiting the covered intangibles are not substantial relative to the revenues generated, or if the principal effect of using covered intangibles is to increase the controlled participant's revenues without affecting their costs (e.g., through a price premium on products that they sell). Sales will be unlikely to be a reliable basis of measurement unless each controlled participant operates at the same level (e.g., manufacturing, distribution, etc.).
3. Operating profit. Operating profit will be a more reliable basis of measurement when such profit is largely attributable to the use of the covered intangibles, or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when the covered intangibles are integral to the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.
4. Other bases for measuring anticipated benefits may be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of the covered intangibles.

Several examples showing the application of indirect bases for measuring anticipated benefits are covered in Treas. Reg. §1.482-7(f)(3)(iii).

Projections that are required in order to estimate the reasonably anticipated benefits may include a determination of the time period between the inception of the research and the receipt of benefits, the time period over which the benefits are expected to be received, and the benefits that are anticipated in each of those years. In situations where the benefit shares of the controlled participants are expected to vary significantly over the years, it may be necessary to use the present discounted value of the projected benefits in order to reliably determine each controlled participant's share of the benefits.[39]

If there is a significant difference between the projected benefit shares and the actual benefit shares, then the IRS/FTB may use actual benefits as the most reliable measure of anticipated benefits. However, no cost allocations based on actual benefits will be made if:

- The difference between each controlled participant's projected benefit share and actual benefit share is less than or equal to 20% of the participant's projected benefit share (For purposes of this test, all controlled participants that are not U.S. persons will generally be treated as a single controlled participant, unless such treatment has the effect of substantially reducing U.S. tax.); or
- The difference between projected and actual benefit shares is due to an extraordinary event that was beyond the control of the participants and could not reasonably have been anticipated at the time that the costs were shared.

Note: Even if the actual benefit shares for each controlled participant are within 20% of the projected benefit shares, costs may be reallocated if the auditor determines that the taxpayer did not use the most reliable basis for measuring anticipated benefits.

Example 3:

Sedan Inc., a foreign corporation and its U.S. subsidiary Limo Co. enter into a cost sharing agreement to develop a new car model. The participants plan to spend four years developing the new model and four years producing and selling the new model. Limo and Sedan project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. The taxpayer determines that projected sales are the most reliable basis for measuring anticipated benefits, so cost shares are divided for each year on that basis. Therefore, Limo bears 66 2/3% ($4 billion / $6 billion total sales) of each year's intangible development costs and Sedan bears 33 1/3% ($2 billion / $6 billion total sales) of such costs.

Example 4:

Bicycle Co., a domestic corporation, and its foreign subsidiaries Trike Co. and Scooter Co. enter into a cost sharing arrangement. The projected and actual benefits of the covered intangibles are in the following proportions:

	Projected	Actual
Bicycle Co.	50%	45%
Trike Co.	30%	25%
Scooter Co.	20%	30%

The actual benefit share received by Bicycle Co. is within 20% of Bicycle's 50% projected benefit share. For purposes of evaluating the reliability of the participant's projections, foreign corporations Trike and Scooter are treated as a single participant. Their combined actual benefit share of 55% is within 20% of their combined projected benefit share of 50%. Therefore the participant's projections of future benefits are considered to be reliable even though Scooter's actual benefit share exceeds its projection by more than 20%.

6. Cost Allocation

For purposes of determining whether a taxpayer's cost allocation is appropriate, the auditor must compare the controlled participant's share of intangible development costs for the income year to its share of reasonably anticipated benefits under the arrangement. A controlled participant's share of intangible development costs is determined by the following formula:[40]

All of the costs incurred by that participant related to the intangible development area	+	All of the cost sharing payments it makes to other controlled and uncontrolled	-	All of the cost sharing payments it receives from other controlled

participants and uncontrolled participants

Over

The sum of the intangible development costs for the year for all the participants. (The intangible development costs for all the participants should be determined as shown in the numerator of this fraction.)

Each controlled participant's share of the reasonably anticipated benefits is equal to its own reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits of all the controlled participants. As discussed above, if the taxpayer did not use the most reliable estimate of reasonably anticipated benefits or if there is a significant difference between actual and projected benefits, then the auditor may make adjustments to the controlled participant's benefit shares before comparing the benefit shares and cost shares.

Example 5:

HiFrequency, Inc. is a domestic corporation and Sound Wave Corporation is its wholly-owned foreign subsidiary. Digital Sound Company is an unrelated third party. HiFrequency, Sound Wave and Digital Sound enter into a cost sharing arrangement to develop new audio technology. Although Digital Sound is a participant in the arrangement, only HiFrequency and Sound Wave are controlled participants. In the first year of the arrangement, the controlled participants incur costs of $2,250,000 in the intangible development area covered by the cost sharing agreement. All of these costs were directly incurred by HiFrequency. Under the terms of the agreement, Sound Wave and Digital Sound make cost sharing payments of $800,000 and $250,000, respectively, to HiFrequency. The intangible development costs borne by the controlled participants are:

	HiFrequency	Sound Wave	Total
Costs incurred by the participant:	$ 2,250,000		
Plus cost sharing payments made to other participants:		$ 800,000	
Minus cost sharing payments received from other participants	-$ 1,050,000		

Intangible development costs borned by controlled participant:	$ 1,200,000	$ 800,000	$ 2,000,000

HiFrequency's share of the intangible developments costs is 60% ($1,200,000 divided by $2,000,000), and Sound Wave's share is 40% ($800,000 divided by $2,000,000).

The auditor has reviewed the basis used by the taxpayer to measure the reasonably anticipated benefits, and agrees that it is the most reliable basis. However, according to the analysis, HiFrequency and Sound Wave each have a 50% share of the reasonably anticipated benefits. Therefore, the taxpayer's cost allocation is not in proportion to the controlled participant's shares of reasonably anticipated benefits. An adjustment will be necessary to make HiFrequency's share of intangible development costs equal to its 50% share of the reasonably anticipated benefits.

7. Change In The Controlled Participants' Interests In Covered Intangibles

If a new controlled participant enters a qualified cost sharing arrangement and acquires an interest in the covered intangibles, then the new participant must pay an arm's-length consideration to the other controlled participants. The amount of the consideration should be determined in accordance with Treas. Reg. §1.482-1, and §1.482-4 through-6.[41]

Likewise, if a controlled participant will receive additional benefits because another controlled participant transferred, abandoned or otherwise relinquished an interest in covered intangibles under the arrangement, then the party relinquishing the interest must receive an arm's-length consideration.[42]

If over the years a controlled participant bears costs of intangible development that are consistently and materially greater or lesser than its share of reasonably anticipated benefits, the auditor may conclude that the economic substance of the arrangement is inconsistent with the terms of the cost sharing agreement. In such a case, the terms of the cost sharing agreement may be disregarded and a new agreement may be imputed consistent with the controlled participant's course of conduct. This will result in treating the controlled participant that bore a disproportionate share of the costs as receiving an additional interest in the covered intangibles. Accordingly, that participant must receive an arm's-length payment from any controlled participant whose share of the intangible development cost is less than its share of reasonably anticipated benefits.[43]

Example 6:

Larry Company, Moe Corp and Curly Company enter into a cost sharing arrangement to develop new products within their rubber chicken product line. Rubber chicken products are manufactured and sold by Larry in North America, by Moe in South America, and by Curly in the rest of the world. Larry, Moe and Curly project that each will manufacture and sell a third of the new rubber chicken products under development, and they share costs on the basis of projected sales of manufactured products. When the new rubber chicken products are developed however, Larry ceases to manufacture rubber chickens. Instead, Curly sells rubber chicken products to Larry for resale in the North American market. Larry earns a return on its resale activity that is appropriate for a distributor, but does not earn a return attributable to exploiting covered intangibles. The auditor determines that Larry's one-third share of the costs was greater than its zero share of reasonably anticipated benefits. Larry will be deemed to have transferred its interest in the covered intangibles to Curly. Larry should therefore receive an arm's-length payment from Curly in consideration for the transfer.

g. Summary

1. For income years beginning after October 6, 1994, Treas. Reg. §1.482-4 contains the 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. The other three methods were discussed in Section 18.6, Water's-Edge Manual.
5. New 1996 regulations established detailed rules for entering into cost sharing arrangements. If intangible development costs have been appropriately shared under the terms of a qualified cost sharing agreement, then no other §482 allocation will generally be required with respect to the intangibles developed under such an arrangement.

This section discussed the methods to be applied when determining the intercompany transfer price for the transfer of intangible property. Section 18.8, Water's-Edge Manual will discuss various audit steps that can be useful when auditing the intercompany transfer price of tangible and intangible property.

Footnotes

1. Treasury Regulations (Treas. Regs.) §1.482-2A(d)(2)(i).
2. Treas. Reg. §1.482-2A(d)(2)(ii).
3. Treas. Reg. §1.482-2A(d)(2)(iii).
4. Treas. Reg. §1.482-2A(d)(4).
5. Treas. Reg. §1.482-4(a).
6. Treas. Reg. §1.482-4(b).
7. Treas. Reg. §1.482-4(c)(1).
8. Treas. Reg. §1.482-1(d)(1).
9. *Finally...Section 482*, Teleconference Handbook, by Internal Revenue Service (IRS) Associate Chief Counsel (International), Associate Commissioner (International and Examination), dated October 27, 1994, page 5.
10. Treas. Reg. §1.482-4(c)(2)(i).
11. Treas. Reg. §1.482-4(b)(2)(ii).
12. Treas. Reg. §1.482-4(c)(2)(ii).
13. Treas. Reg. §1.482-4(c)(2)(iii)(B).
14. Treas. Reg. §1.482-4(c)(2)(iii)(B)(ii).
15. Treas. Reg. §1.482-4(c)(2)(iii)(B)(2).
16. Ibid., note #9, page 7.
17. Ibid., note #16.
18. Treas. Reg. §1.482-4(f)(2)(B).
19. Treas. Reg. §1.482-4(f)(2)(C).
20. Ibid., note #16.
21. Ibid., note #16.
22. Ibid., note #16.
23. Ibid., note #9, page 8.
24. Ibid., note #23.
25. Treas. Reg. §1.482-1(h)(3).
26. *Transfer Pricing: The Code and The Regulations*, Tax Management Foreign Income Portfolios (BNA) No. 887, by John P. Warner, Esq., page A-105.
27. Treas. Reg. §1.482-4(f)(4).
28. Treas. Reg. §1.482-4(f)(5).
29. Treas. Reg. §1.482-7(a)(1)
30. Treas. Reg. §1.482-7(b)
31. Treas. Reg. §1.482-7(c)(1)
32. Treas. Reg. §1.482-7(c)(2)(i)

33. Treas. Reg. §1.482-7(c)(5)
34. Treas. Reg. §1.482-7(d)(1)
35. Treas. Reg. §1.482-7(g)(2)
36. Treas. Reg. §1.482-7(d)(1)
37. Treas. Reg. §1.482-7(e)
38. Treas. Reg. §1.482-7(f)(3)
39. Treas. Reg. §1.482-7(f)(3)(iv)
40. Treas. Reg. §1.482-7(d)(1)
41. Treas. Reg. §1.482-7(g)(3)
42. Treas. Reg. §1.482-7(g)(4)
43. Treas. Reg. §1.482-7(g)(5)

Section 18.8 Intercompany Transfer Pricing Tangible And Intangible Property, Examination Guidelines

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References:

Revenue and Taxation Code §24725
Revenue and Taxation Code §25114
California Code of Regulations §25114
Internal Revenue Code §482
Treasury Regulations §1.482-1 through §1.482-8

Training Objectives:

The *Introduction*, §18.1, discussed the evaluation of whether IRC §482 noncompliance exists. This section of the chapter will be useful when the results of that evaluation indicate that an intercompany transfer pricing issue must be pursued. This section offers some audit steps to consider when determining an arm's length price for the transfer of tangible and intangible property.

a. Introduction

When examining a multinational corporation for a potential pricing issue it is important to be as organized as possible. A working knowledge of Internal Revenue Code (IRC) §482 and the Treasury Regulations (TR) §1.482-1 through TR §1.482-8 is a prerequisite to planning a strategy of how to approach such an examination. This section, *Tangible and Intangible Property, Examination Guidelines*, is intended be useful after the decision has been made that an intercompany pricing issue with respect to the transfer of tangible and intangible property will be pursued.

Section 18.1, Water's-Edge Manual discussed the general concepts of IRC §482 while Section 18.2, Water's-Edge Manual through Section 18.4, Water's-Edge Manual discussed the application of TR §1.482-2(a), (b) and (c) to intercompany loans, the intercompany performance of services and the intercompany use of tangible property. Section 18.5, Water's-Edge Manual discussed the general concepts resulting from the regulations finalized in 1994 while Section 18.6, Water's-Edge Manual and Section 18.7, Water's-Edge Manual discussed the application of TR §1.482-3 through TR §1.482-7 to the intercompany transfer of tangible and intangible property.

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

Review Section 18.1(j), Water's-Edge Manual (*FTB Audit Responsibility)*. That section discussed FTB's audit responsibility in general and the evaluation of potential noncompliance with §482. Because RTC §25114 directs FTB to examine water's-edge returns for potential noncompliance, an evaluation of potential intercompany pricing issues in required for every water's-edge case. Because there are no bright-line tests to determine the materiality of a potential pricing issue, the auditor must evaluate the taxpayer's facts and circumstances to determine whether a §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 must be evaluated by using a list of factors, including the:

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

These factors were discussed in more detail in Section 18.5(d), Water's-Edge Manual. There is no standard approach or solution to any IRC §482 issue. Each case is decided on its own peculiar set of facts. To make a proper determination, the auditor must obtain all the relevant facts and understand the circumstances related to the taxpayer and its industry.

b. Organization Of The Examination

One of the most difficult areas in IRC §482 allocations involves the transfer pricing of goods among related entities. You must 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.

What makes a pricing case so difficult is the lack of 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, reliance on more subjective criteria must be done 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, it must be shown 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 a §482 audit what information can be of the most value. For example, a pricing method can not 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.

   The approach that the auditor should take is to 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, the auditor can begin to evaluate what the best pricing method(s) will be, and focus subsequent information gathering on items that will be relevant for application of that method(s). It is important to resist the temptation to become "locked in" to a particular method however. If facts are developed which indicate that another pricing method may be more appropriate, the auditor must be willing to refocus the fact gathering in light of the new method.

Chapter 20A, Water's-Edge Manual and Chapter 20B, Water's-Edge Manual discuss the record maintenance requirements placed on taxpayers for purposes of IRC §482 and the penalties which can be imposed when the taxpayers fail to maintain these records. Refer to these chapters in situations where taxpayers are not being cooperative about providing the documentation you need for the audit.

3. 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.

4. Determine an arm's length price or standard. This is a difficult part of the examination because it is so subjective. 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 us 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. In order to understand what the numbers mean, you must 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 income 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.[1] Both of these types of analysis should be performed.

A preliminary ratio and trend analysis should be done as a step in evaluating potential pricing noncompliance prior to even recommending the case for a §482 audit. However, as the audit progresses and the auditor obtains 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:

1) Gross profit ratio;
2) Berry ratio (gross profit/operating expenses);
3) Return on assets;
4) Return on sales;
5) Inventory turnover rate; and
6) 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

It should be standard practice to 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 in order 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:

1. Trade magazines relating to the taxpayer's business;
2. Articles about the taxpayer written in various periodicals;
3. An extensive review of the taxpayer's operations, e.g., a complete functional analysis; and
4. 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 and reports; 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

You should 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 comparable's 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

Every attempt should be made to 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 affiliate's accounting records for the manufacturing and distribution costs for the products sold to the taxpayer.

g. Functional Analysis

You are already familiar with the necessity of performing a functional analysis to determine whether there is a unitary relationship between affiliated corporations, and are aware of the volume of information required. For a pricing case, or any other IRC §482 case, you will also need to 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:[2]

a. What was done?
b. What economically significant functions were involved in doing it?

c. Who performed each function?
d. What is the measure of the economic value of each function performed by each party?
e. What economic risks were assumed?
f. 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, 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. Text §523 of IRM offers guidelines for this phase of the examination. A thorough study of this section of the IRM is valuable because it offers a way to organize the examination. The taxpayers are also very aware of this section 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.[3]

i. Site Tour

It may be necessary to conduct a site tour and interviews with key personnel. Here are several items to consider.

A. Why do a site tour?

- To visualize the operations and relevant processes;
- To understand the technical jargon;
- Learn jobs and names of potential witnesses to interview;
- Gain insight into the taxpayer's position, e.g., what are their reasons for believing that the manufacturing site is worthy of a high profit; and
- Discover potential factual issues, e.g., additional parent assistance in the operations.

B. Where to go?

- Manufacturing plants; parent company; raw material, intermediate or end product manufacturing sites; pilot plants; marketing offices; research and development facilities; quality control; distribution centers and warehouses.
- Comparable sites of the taxpayer's competitor or potential comparables.

C. What to do in advance?

- Get site layout or map and photos. Study the facility and operations as much as possible;
- Arrange appointments with the personnel that will perform the tour;
- Describe and understand what will be viewed. Obtain agreement with the taxpayer;
- Get organization charts and resumes or job descriptions for employees. Determine who will be interviewed. Arrange appointments with key personnel to be interviewed at the site. Leave sufficient time between interviews. If possible, make interview appointments on different days.
- Have necessary experts available;
- Attempt to acquire intercompany correspondence; and
- In addition to our own version, obtain the company's version of a functional analysis, e.g., flow chart or list of functions.

D. Who to take with you?

- Auditors;
- Economists, if they will be assigned to the case;
- Attorneys; and
- Engineers or other experts if a consulting contract is in effect.

E. What to do on tour?

- Take a group to gather as much information as possible. Ask questions of various plant personnel. Use your expert's knowledge.
- Take more than one day if possible, e.g., permits clarification of questions that come to you later.
- Memorialize interviews and the tour as soon as possible. Compare notes every night. Use a tape recorder if the taxpayer allows. Offer the taxpayer a copy of the tapes.

j. Search For Comparables

1. Third Party Comparables

While searching for arm's length comparables, search for acceptable comparable transactions from within the taxpayer's controlled group. Otherwise, it will be necessary to obtain the necessary information from third parties, who are not related to the taxpayer but who have similar business operations. For example, a foreign parent corporation sells VCRs both to its United States subsidiary and to a major retailer, who is not related. The VCRs sold to the unrelated retailer are almost identical to those sold to the United States subsidiary without the parent's trade name. The unrelated transaction would be used to compare to the related transaction, but an adjustment must be made to consider the trade name and other circumstances of sale. For purposes of the regulations, the method employed would not be considered a CUP method, but a resale price method because of the trade name.

If the foreign parent made no sales to an independent retailer, other distributors of VCRs, who purchase their product from an independent source, must be reviewed. Failing that, the search can be expanded to distributors of similar consumer products who purchased products from an independent source.

If it is necessary to contact third parties for comparable data, you should exercise care concerning unnecessary disclosure of taxpayer information. Notify the taxpayer beforehand that you will be contacting third parties. Do not promise the third party either explicitly or implicitly that the information will be kept confidential since the third party may be needed in the event of a trial.

2. How Do You Find Comparables

Does the taxpayer have sales of similar products to third-parties? Are the terms of sale comparable? Can any differences be quantified?

Using the taxpayer's three-digit SIC code, use reference sources such as <u>Moody's</u> and <u>Standard and Poor's</u> to identify comparable entities. A functional analysis of the comparable is required to determine if these entities are truly comparable to the taxpayer.

Ask the taxpayer to identify their customers. Contact the customer to see if they buy from anyone else or have data on wholesalers engaged in the same line of business as the taxpayer. Ask the taxpayer to identify their competitors.

Finally, ask the taxpayer to explain their pricing methodology. For income years beginning after April 21, 1993, for federal purposes taxpayers are required to provide documentation supporting the transfer pricing method being applied contemporaneous to the timely filed return or the taxpayer can be subject to IRC §6662(e) penalties.[4]

k. Sources Of Information

Library reference materials for identifying third-party comparables include the following sources.

1. *Almanac of Business and Industrial Financial Ratios*, by Leo Troy, Ph.D.:
    a. Financial ratio analysis by SIC code by corporation size.
    b. Lists corporations with net income and corporations without net income.
    c. Source includes both private and public corporations.
2. *Business-to-Business Yellow Page Directory*:
    a. Published by local telephone companies.
3. *Corporate & Industry Research Reports*, published by RR Bowker, a division of Reed Publishing:
    a. Microfiche collection containing over 150,000 reports generated by major securities firms since 1982.
    b. Research reports are listed in three different manners: name of security firm issuing the report, name of company analyzed in the report, and name of particular industry analyzed in the report.
4. *Corporate Yellow Book*, published by Monitor Publishing Company:
    a. Identifies top executives at over 1,000 leading United States companies and 6,000 major subsidiaries.
5. *Directory of Corporate Affiliations*, the six-volume set is published annually by National Register Publishing:
    a. Provides an alphabetical listing of corporations with ownership information.
    b. Provides information for both public and private corporations operating in the United States and outside of the United States with revenues in excess of $10,000,000.
    c. Contains a brand name index, which ties a brand name product to the owner.
    d. Contains a geographic index to United States and Non-United States locations.
6. *Directory of Manufacturer's Sales Agents*, published by the Manufacturer's Agent's National Association:
    a. Lists the names and addresses of sales agents by product category.Note: Agents are experts in a particular business area and can provide valuable information in identifying comparables.
    b. Published annually.

7. *Dun & Bradstreet Million Dollar Directory*:
   a. Basic financial information with over 160,000 businesses, both public and private. Published annually.
   b. Companies listed have $25 million or more in sales volume or net worth greater than $500,000.
   c. Companies are listed alphabetically, by SIC codes and geographically by state and city.
   d. Information includes, among others: name and address; officer's names; sales volume; brief business description; and whether company is a subsidiary.
8. *Encyclopedia of Associations*, published by Gale Research, Inc.:
   a. Lists over 22,000 national organizations, including but not limited to trade and business associations.
9. *The Federal Statistical Source: Where to Find Agency Experts and Personnel*:
   a. This source lists over 4,000 entries for key persons responsible for the development, collection and dissemination of federal statistics.
10. *Federal Yellow Book*, published by the Monitor Publishing Company:
    a. Identifies key officials throughout the United States government.
    b. Listings for these United States Department of Commerce offices can be particularly helpful: Bureau of Economic Analysis, where one can contact specialists for all major United States industries; and international Trade Administration, where one can obtain information about prior and current anti-dumping investigations.
11. *Moody's Industrial Manual*:
    a. Published annually; lists all publicly held companies with SEC filing requirements.
    b. Information includes, among others, detailed business descriptions and 7-year presentation of profit and loss, balance sheets and operating ratios.
12. *RMA Annual Statement Studies*, published annually by Robert Morris Associates:
    a. Provides a financial ratio analysis by 16 widely used ratios for 313 industries in five categories: manufacturing, wholesaling, retaining, servicing and contracting.
    b. Provides the ratio formulas and descriptions of the purpose of each formula.

   c. Current year data stated by corporation asset size, e.g., $0-$500 Million, $500-$2,000 Million, etc.,) based on 107,000 financial statements.

13. *Standard & Poor's Corporation Records*:
   a. Same detailed information as that shown in <u>Moody's</u> for public corporations.
   b. 10-year presentation of financial information.

14. *Standard & Poor's Industry Surveys*:
   a. Two-volume set published quarterly.
   b. Surveys address all major domestic industries:
      i) Basic analysis provides in-depth treatment of fundamental market conditions; and
      ii) Current analysis highlights new market developments.

15. *Statistics of Income: Corporation Income Tax Returns*, published annually by the IRS:
   a. Presents operating statistics based on corporate income tax returns grouped according to major and minor industrial divisions.
   b. Lists statistics including such items as the number of returns, total complied receipts and net income.

16. *Thomas Register of American Manufacturers*, published annually by Thomas Publishing Company:
   a. Provides a listing of over 100,000 United States manufacturers, their products and services, brand names and catalogs.

17. *The United States Government Manual*, revised annually:
   a. An official handbook of the federal government.
   b. Lists comprehensive information on the agencies of legislative, judicial and executive branches.
   c. Includes information on quasi-official agencies, international organizations, boards, commissions and committees.
   d. Agency description includes description of its programs and activities and a Source of Information section, e.g., information on consumer activities, contracts and grants, employment and publications.

18. *Ward's Business Directory*:
   a. Contains listing of 107,000 businesses, both public and private.
   b. Similar information and format as that in *Dun & Bradstreet*.

19. *Where to Find Business Information*:

    a. A worldwide guide for the answers to business questions.
    b. Lists in alphabetical order more than 2,500 subjects covered by business publications.
    c. Shows precisely and quickly where current business information is located and how to get it.[5]

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 a fluctuation of exchange rates.

In connection with determining the basis on which the price was calculated, the auditor 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.[6]

m. 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.

Footnotes

1. *How To Find Negligence And Misrepresentations in Financial Statements*, by Irving Kellogg, 1983.
2. Internal Revenue Manual (IRM), page 523.2, dated March 11, 1985.
3. Ibid., page 523.1.
4. *Guide To Transfer Pricing Compliance*, by Charles Triplett, Esq., dated August 1994, tab 800, 830, page 35.
5. *Finally...Section 482*, Teleconference Handbook, by Internal Revenue Service (IRS) Associate Chief Counsel (International), Associate Commissioner (International and Examination), dated October 27, 1994, pages 113-115.
6. Ibid., page 523.6.