I.R.C. Section 482: Transfer Pricing 1994 Final Regulations

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1994 Final Regulations

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Introduction

With increased globalization of the economy, many companies are becoming multinational and entering into controlled transactions across foreign borders. This may cause problems to arise as companies set prices for goods (both tangible and intangible) sold among a parent company and its subsidiaries. Without any type of regulation, companies may set these transfer prices arbitrarily. In certain situations, a parent company may be located in a country, such as the United States, where tax rates reach as high as 35% while its subsidiary is located elsewhere (such as Puerto Rico or Ireland) where lower tax rates are applicable. In this situation, the parent would be able to lower the overall tax liability by shifting income to its subsidiaries.

By allowing companies to set income arbitrarily, governments such as the United States are losing tax revenues. These losses inspired the research behind the White Paper, the study that influenced the recent changes in the Internal Revenue Code (I.R.C.) §482 Regulations. The White Paper noted dramatic increases in foreign direct investment in the United States while foreign controlled companies (FCCs) reported substantially lower than average profits on their U.S. income tax returns.¹ This implies that the FCCs were taking advantage of operations within the U.S. without paying their related share of taxes; essentially, they were shifting income from the United States. One university study determined that the United States lost $33 billion in tax revenues in 1993 alone due to such transfer pricing abuses.² The U.S. government has taken the stand that companies who are

shifting income outside the U.S. are essentially evading their respective tax liabilities. Therefore, the government has reevaluated its transfer pricing policies with respect to income taxes.

"The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions."³ In order to accomplish this task, §482 allows the Internal Revenue Service (IRS) to reallocate arbitrarily set income so that companies operating within the United States must pay their appropriate share of taxes. In other words, the section was created to increase income tax revenues by reallocating income. This reallocation may be accomplished through several methods that place the taxpayer on an even parity with taxpayers in uncontrolled transactions. The key to §482 is creating arm’s length transactions. (Details about the methods utilized in §482 may be found beginning on page 23.)

In determining who is subject to §482, the Committee Report on P.L. 99-514 addresses outbound companies specifically. Outbound companies are those that ship tangible and intangible goods outside the United States to subsidiaries in foreign companies. This type of company is in contrast to inbound companies which ship goods from foreign companies into the U.S. Section 482 is not limited to outbound companies, however; the conference report states that it is also applicable to inbound companies. The purpose of this paper is to discuss the recent issuance of the finalized §482 regulations and their implications to taxpayers.

³ Reg. §1.482-1T(a)(1)
Historical Information

Forerunners

The first indicator that the IRS considered transactions between foreign affiliated companies to be troublesome was in 1917. In the War Revenue Act of 1917 the Commissioner was given general authority to allocate income and deductions by requiring consolidated returns. Eventually, the Commissioner could not only require, but could also prepare consolidated returns for commonly controlled companies. This authority was found in the Revenue Act of 1921 that later led to §45 in the 1928 Revenue Act, a direct predecessor of §482. In section 45 the Commissioner was given the authority to prevent tax avoidance and ensure clear reflection of income to determine "true tax liability." This is the same purpose that is currently stated in §482, as found on page four of this paper.

From 1917 until the 1960s the predecessors of §482 were used for domestic purposes. During this time the arm’s length standard was also created. The 1935 Treasury Regulation for §45 stated “The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.” Despite the attempts to ensure that transfer prices were being set at arm’s length, the Treasury Department stated in 1961 that §482 was not effectively protecting the U.S. jurisdiction.

As a result of the Treasury Department’s concerns, legislative proposals were made to reduce difficulties in determining “fair price” especially where “thousands of different

4 1988-2 C.B. 458
5 1988-2 C.B. 459
6 1988-2 C.B. 459
7 1988-2 C.B. 459
8 1988-2 C.B. 460
transactions” were occurring between related parties. The House of Representatives proposed a comparable uncontrolled price method and, in instances where this method was not applicable, a formula for relative economic activities. Also, the House stated that no allocation was to be made to foreign organizations whose assets were grossly inadequate for the activities conducted outside the U.S. The Senate, however, did not agree with these changes and instead a joint committee found that:

“The Treasury should explore the possibility of developing and promulgating regulations under [the broad authority given to the Secretary of Treasury or his delegate to allocate income and deductions] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.”

1968 Regulations

As a result of this finding, the Treasury Department issued Regulations in 1968 that were applicable through 1993. These regulations reaffirmed the arm’s length standard that was set forth in 1935 (see page five). Included in the regulations was a discussion of three types of transfers: I) services, II) intangibles and III) tangibles.

I) With regard to services, the regulations provided that transfer prices should be set by comparing a transaction to the same or similar independent transactions of unrelated parties with similar circumstances. No specific method was given for the comparison.

II) Intangibles were given similar treatment as services, but, in addition, the regulations set out certain factors to use when difficulties arose in comparing intangibles. No weight was given to any of the factors so taxpayers were on their own to determine which factors should be given more importance.

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9 1988-2 C.B. 460
10 1988-2 C.B. 460
11 1988-2 C.B. 460
Finally, the regulations set forth three methods to be used in determining the
transfer prices of tangible property. These methods were:

1. Comparable uncontrolled price method,
2. Resale price method, and
3. Cost plus method.

These three methods were to be used in the order set forth above, yet little guidance was
given when no comparables existed. The regulations did, however, make a provision for
unspecified methods to be used when none of the three methods previously mentioned were
applicable.

"When none of the three methods of pricing...can reasonably be applied under the facts and
circumstances as they exist in a particular case, some appropriate methods of pricing other
than those described [above] or variations on such methods, can be used"\(^{12}\)

This became commonly known as "fourth methods".

In 1986, Congress expressed displeasure of the administration of §482. Poor
administration was partially due to problems that existed in obtaining relevant information
on a timely basis. Since importance was placed on the time to close an examination, often
the examinations were closed before pertinent information was ever obtained. This meant
that §482 was not being applied effectively and revenues were being lost. One reason
leading to information not being obtained was that U.S. subsidiaries did not have certain
information and were unable to obtain it from foreign parents. Often the parent
corporations were not under similar information reporting requirements as U.S.
subsidiaries which increased the problem.

\(^{12}1988-2\text{ C.B. }461\)
Proposed Regulations

The 1993 Proposed Regulations were part of an eight year effort to rectify problems in the 1968 Regulations. Along with poor administration, the 1993 Proposed Regulations dealt with the vagueness of the 1968 Regulations. For example, placing value on intangibles is often difficult, especially when they are linked to services and tangibles. As stated on page six, no methods were specified in the 1968 Regulations to compare transactions involving services or intangibles. So should the focus be on the tangible property transferred without regard to related intangibles or services? Section 482 was intended to alleviate problems that may arise in foreign controlled transactions, yet it was vague and not administered effectively.

Final Regulations

The final regulations issued on June 1, 1994, and reissued July 8, 1994 responded to criticisms made by taxpayers and foreign tax authorities about the 1993 proposed regulations. The final regulations are very similar to the 1968 regulations, yet they are more explicit as to the procedures and methodology to be used in applying the section; these changes, which are to correct the problems of lost tax revenues due to transfer pricing, are generally effective for tax years beginning after October 6, 1994. Important to note is that §482 may be applied retroactively to any open tax year.

Regulations

Purpose

The purpose of Regulation §1.482 "is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of tax."\(^{14}\) As mentioned on page five, this principle is carried over from §45 of the 1935 Regulations. The Regulations set forth in 1994 explain the methods that the district director (and taxpayers) may use to ensure that this purpose is achieved.

Allocations

"The district director may make general allocations between members of a controlled group if a controlled taxpayer has not reported its true taxable income."\(^{15}\) (Refer to the Appendix to obtain an understanding of the terminology that will be used throughout this paper.) The allocations that may be made pertain to income, expenses, deductions, or any other factor as it relates to transfer pricing that may change taxable income. For example, FM, a foreign manufacturer, sells goods to its U.S. subsidiary, a retailer. If the manufacturer charges a price that is above what is considered an arm's length price, then the district director may allocate the expense of cost of goods sold from the subsidiary to FM.

To comply with §482, taxpayers may report income based on prices different from those actually charged. However, "No untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled

\(^{14}\) Reg. §1.482-1(a)(1)
\(^{15}\) Reg. §1.482-1(a)(2)
transactions.”\(^{16}\) In other words, the intent of §482 is to increase tax liability when controlled taxpayers are believed to be shifting income; these taxpayers may not use §482 to decrease tax liabilities unless such results are reported in a timely manner and are consistent with the arm’s length standard.

“If the district director makes an allocation of income, the district director will not only increase the income of one member of the group, but correspondingly decrease the income of the other member.”\(^{17}\) Essentially, increases must correspond to decreases to the extent that they will affect U.S. income tax. The adjustments made to one party has the potential of changing the U.S. tax liability for other parties involved in the controlled transaction. Such effects, however, may not transpire since other controlled parties are operating in foreign countries. The effect that adjustments have on foreign income tax is dependent on the individual country’s tax laws.

“If an allocation is made under section 482 with respect to a transaction between controlled taxpayers, the district director will also take into account the effect of any other non-arm’s length transactions between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation.”\(^{18}\) This has the result of producing the net effect of controlled transactions on income tax liabilities. In order for such setoff to occur, however, the taxpayer has the responsibility of bringing other controlled transactions to the district director’s attention. In so doing, adjustments will be made only if the taxpayer:

“(A) Establishes that the transaction that is the basis of the setoff was not at arm’s length and the amount of the appropriate arm’s length charge;

(B) Documents...all correlative adjustments resulting form the proposed setoff; and

\(^{16}\) Reg. §1.482-1(a)(3)

\(^{17}\) Reg. §1.482-1(g)(2)(i)

\(^{18}\) Reg. §1.482-1(g)(4)(i)
(C) Notifies the district director of the basis of any claimed setoff within 30 days after the earlier of the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or the date of the issuance of the notice of deficiency.19

The paragraphs above describe situations where adjustment may be made to reflect true taxable income. Certain circumstances, however, may lead to an otherwise qualifying adjustment not being made. A foreign legal restriction may be such a circumstance “to the extent that it is shown that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time.”20 Such restrictions must be publicly announced, the taxpayer must have exhausted all remedies prescribed by foreign law for obtaining waiver of such restrictions, the restrictions must have expressly prevented the payment or receipt of part or all of the arm’s length amount and the taxpayer must not have violated the restriction.21

The income described above may be deferred if the taxpayer establishes that payment or receipt was prevented because of the foreign legal restriction. (The taxpayer must also use the deferred income method of accounting.) In this case, income will be “treated as deferrable until payment or receipt of the relevant item ceases to be prevented by the foreign legal restriction. Income may not, however, be deferred unless it exceeds the related deductions already claimed in open taxable years to which the foreign legal restriction applied.”22 In other words, the deferral of income due to a foreign legal restriction may not cause a loss if deductions are being taken.

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19 Reg. §1.482-1(g)(4)(ii)
20 Reg. §1.482-1(h)(2)(i)
21 Reg. §1.482-1(h)(2)(ii)(A)-(D)
22 Reg. §1.482-1(h)(2)(iv)
Arm's Length Standard

"A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that could have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances."\(^{23}\) In instances where the same transaction and circumstances cannot be found, comparable transactions under comparable circumstances may be analyzed. Reverting to comparable transactions and circumstances decreases the reliability of determining the arm's length standard.

When determining whether or not a taxpayer is operating at an arm's length standard, the arm's length range is often used. If a taxpayer's results fall within such range then no adjustments will be made under §482.\(^{24}\) The arm's length range is "ordinarily determined by applying a single pricing method to two or more uncontrolled transactions of similar comparability and reliability."\(^{25}\) (See page 14.) The arm's length result will include transactions where "the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference."\(^{26}\)

\(^{23}\) Reg. §1.482-1(b)(1)  
\(^{24}\) Reg. §1.482-1(e)(1)  
\(^{25}\) Reg. §1.482-1(e)(2)(i)  
\(^{26}\) Reg. §1.482-1(e)(2)(iii)
The interquartile range is the method generally preferred to create the arm's length range. The interquartile range consists of all results that have a 75% probability of falling below the upper limit and a 75% chance of falling above the lower end of possible results. In other words, the acceptable range is the middle 50% which would fall between the two lines below:

\[
\begin{array}{ccc}
1 & 2 & 3 \\
4 & 5 & 6 \\
7 & 8 & 9 \\
\end{array}
\]

If the taxpayer can show that its results are within the interquartile range, then no adjustments will be made. If a taxpayer’s results do not fall within the arm’s length range, the district director may make allocations. Generally, such adjustments will be made so that the new results fall at the median of the interquartile range, although any point is acceptable.

Allocations may be made regardless of the reasons why the results are not within the arm’s length range. This means that the “intent to evade or avoid tax [is] not a prerequisite” for a §482 allocation.\textsuperscript{27} In addition, the realization of income is not required, as illustrated in the following example: “A controlled taxpayer sells a product at less than an arm’s length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year. The district director may make an appropriate allocation to reflect an arm’s length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first taxable year.”\textsuperscript{28}

\textsuperscript{27} Reg. §1.482-1(f)(1)(i)
\textsuperscript{28} Reg. §1.482-1(f)(1)(ii)(A)
Finally, the “district director may make an allocation under §482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code.” For example, §351 allows for nonrecognition of gain on the incorporation of a business when certain requirements are met. If a transaction falls under the provisions of §482, the district director may allocate gain despite §351.

**Comparability**

In order for an uncontrolled transaction to be used to determine the arm’s length price for a controlled transaction, the two transactions must be comparable. This comparability relies on the “completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data assumptions.” The reliability of the assumptions relates to the underlying principles behind each of the different methods. Adjustments that are made for economic principles, such as the time value of money, are more reliable than adjustments that make assumptions about the market value of intangibles because the underlying principles behind the former adjustments are more reliable. Adjustments that must be made will vary from method to method as will the sensitivity of the results to deficiencies in data assumptions for different methods. “For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method.

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29 Reg. §1.482-1(f)(1)(iii)(A)
30 Reg. §1-482-1(c)(2)(ii)
31 Reg. §1-482-1(c)(2)(ii)(B)
analysis (See page 23 and 26).”\textsuperscript{32} This results because management efficiency will affect variances in profit more than variances in price.

Comparability of the transactions should be achieved considering the following factors as stated in Regulation §1.482-1(d)(1):

(i) functions;
(ii) contractual terms;
(iii) risks;
(iv) economic condition; and
(v) property or services

If significant differences between transactions exist concerning these factors, then adjustments must be made to increase comparability. “If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm’s length result, but the reliability of the analysis will be reduced.”\textsuperscript{33}

(i) Functions

Functional analysis compares economically significant activities and resources employed in controlled and uncontrolled transactions.\textsuperscript{34} Examples of functions that the regulations consider relevant are: research and development; manufacturing, production and process engineering; and marketing and distribution functions.\textsuperscript{35} So, if a taxpayer transfers a product that is subject to substantial research and development to a controlled taxpayer that uses extensive marketing and distribution channels, uncontrolled taxpayers would have to participate in the same activities for the transaction to be comparable. If the first uncontrolled taxpayer focused on manufacturing (as opposed to research and

\textsuperscript{32} Reg. §1-482-1(c)(2)(ii)(C)
\textsuperscript{33} Reg. §1-482-1(d)(2)
\textsuperscript{34} Reg. §1.482-1(d)(3)(i)
\textsuperscript{35} Reg. §1.482-1(d)(3)(i)
development) of the product transferred, then the transaction would be less comparable and thus less reliable.

(ii) Contractual Terms

Contractual terms that affect comparability include: the form of consideration charged or paid; sales or purchasing volume; scope and terms of warranties provided; and, the extension of credit and payment terms.\(^{36}\) Parties to controlled transactions have a tendency to offer better terms than they would if involved in an uncontrolled transaction. For example, payment terms may be net 90 for a controlled transaction instead of the net 30 normally offered for an uncontrolled transaction. In order to be comparable, adjustments in terms, as well as a corresponding adjustment of price must be made.

When terms between controlled taxpayers are agreed to in writing the district director will generally respect the terms “if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, the greatest weight will be given to the actual conduct of the parties.”\(^{37}\) This follows the principle of substance over form that is often employed by the IRS. If the district director feels that parties involved in a controlled transaction are not acting in accordance with the terms of their contract, then “the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.”\(^{38}\) The district director may also apply substance over form if there is no written agreement -- the most weight will be given to the economic substance of the transaction and terms will be imputed.

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\(^{36}\) Reg. §1.482-1(d)(3)(ii)(A)

\(^{37}\) Reg. §1-482-1 (d)(3)(ii)(B)

\(^{38}\) Reg. §1-482-1 (d)(3)(ii)(B)
(iii) Risks

The risks associated with transactions must be allocated to the various parties involved with the transfers. "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." The risks that are generally considered under this section are: market risks; risks associated with the success or failure of research and development (R&D); financial risks; credit and collection risks; product liability risks; and general business risks. The allocation of risks to controlled taxpayers should be similar to the allocation of risks to uncontrolled taxpayers to ensure comparability and thus reliability of the results achieved.

(iv) Economic Conditions

Economic conditions include consideration of geographic markets and relative size or economic development of these markets. For this section, "A geographic market is any geographic area in which the economic conditions for the relevant product or service are substantially the same." "If information from the same geographic market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets." In this instance, two companies operating within different markets may have to make adjustments to account for differing costs in the geographic regions. One should be careful when making such adjustments, however, because they may affect the reliability of the information obtained.

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39 Reg. §1.482-1(d)(3)(iii)(B)
40 Reg. §1.482-1(d)(3)(iii)(A)
41 Reg. §1.482-1(d)(4)(ii)
Other economic conditions that affect comparability are the level of market (for example retailer or wholesaler), relevant market share, extent of competition, and economic conditions of the particular industry.\textsuperscript{42} A transaction conducted in the U.S. is not likely to be comparable to one conducted in Brazil due to difference economic conditions. However, a controlled transaction conducted between a Brazilian manufacturer and a U.S. retailer may be comparable to an uncontrolled transaction between a Puerto Rican manufacturer and U.S. retailer if Brazilian and Puerto Rican economic conditions are similar.

**Property or Services**
Finally, "the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transaction. This comparison may include any intangibles that are embedded in tangible property or services."\textsuperscript{43} In other words, the transfer of a drug that is protected by patent will not be considered comparable to the transfer of a shoe. Transferred goods must be of a similar nature with respect to the object transferred as well as with the intangible involved (i.e., brand name, patent, trademark) in order to be comparable. This means that the transfer of the drug mentioned above also will not be comparable to the transfer of a drug without a patent.

**Special Circumstances**
Special circumstances may increase the difficulty of comparing controlled and uncontrolled transactions. In some instances companies may have unusually high marketing costs due to a strategy aimed at increasing market share. "The effect of a market share

\textsuperscript{42} Reg. §1-482-1(d)(3)(iv)
\textsuperscript{43} Reg. §1.482-1(d)(3)(v)
strategy on a controlled transaction will be taken into account only if it can be shown that an uncontrolled taxpayer engaged in a comparable strategy under comparable circumstances for a comparable period of time.”\textsuperscript{44} The taxpayer must also show that “costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future benefits; the strategy is pursued for a period of time that is reasonable; and the strategy and the related costs and benefits were established before the strategy was implemented.”\textsuperscript{45}

Other special circumstances also require special considerations when comparing controlled transactions to uncontrolled transactions. For example, “[t]he combined effect of two or more separate transactions…may be considered, if such transactions…are so interrelated that the consideration of multiple transactions is the most reliable means of determining the arm’s length consideration.”\textsuperscript{46} This is the case that occurs when intangibles are embedded in tangible property. Since separating the intangible is so difficult, considering the two transactions together would produce more reliable results.

Another special circumstance occurs when it is “appropriate to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review.”\textsuperscript{47} In this instance data from the same years should be used for both the controlled and uncontrolled taxpayers unless adjustments are made to the factors of comparability discussed on page 15. Multiple year data may be warranted if the data for the taxable year under review is incomplete or inaccurate, business cycles in

\textsuperscript{44} Reg. §1.482-1(d)(4)(i)
\textsuperscript{45} Reg. §1.482-1(d)(4)(i)(A)-(C)
\textsuperscript{46} Reg. §1.482-1(f)(2)(i)(A)
\textsuperscript{47} Reg. §1.482-1(f)(2)(iii)(A)
the controlled taxpayer's industry effect multiple tax years, or life cycles of the product or intangible being examined effect multiple tax years.\textsuperscript{48}

In addition, "[d]ata from multiple years may be considered to determine whether the same economic conditions that caused the controlled taxpayer's results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm's length range."\textsuperscript{49} This may become particularly relevant when determining if the results occurring from the implementation of a market share strategy are at arm's length. As discussed on page 19, a controlled taxpayer must prove that an uncontrolled taxpayer engaged in similar activities under similar circumstances over a comparable period of time.

Despite special allowances made above, certain transactions will not be accepted as uncontrolled comparables capable of establishing the arm's length standard. These include transactions that are not completed in the ordinary course of business and those that occur only to establish the arm's length standard. This provision prevents controlled taxpayers from setting their own arm's length standard by offering unusual conditions to uncontrolled taxpayers.

\textbf{Methods}

The Treasury Regulations set forth the following methods that may be used to determine the proper arm's length amount for a controlled transaction. These methods are:

1. Comparable uncontrolled price method;
2. Resale price method;
3. Cost plus method;

\textsuperscript{48} Reg. \textsection 1.482-1(f)(2)(iii)(B)  
\textsuperscript{49} Reg. \textsection 1.482-1(f)(2)(iii)(C)
4. Comparable profits method;
5. Profit split method; and,
6. Unspecified methods

**Best Method Rule**

In determining which of these methods is most appropriate, the regulations set forth the “best method rule” which states that the method to be used is “the method that, under the facts and circumstances, provides the most reliable measure of an arm’s length result.”50 A taxpayer may choose to use any method as long as it produces an arm’s length result. However, “If another method is subsequently shown to produce a more reliable measure of an arm’s length result, such other method must be used.”51 In determining which method is the “best method” the “degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis” must be considered.52 Important to note, however, is that the results will be analyzed to determine if they fall into the arm’s length standard, regardless of the method applied. This is another where the IRS applies the principle of substance over form. (See page 16.)

The reliability of the results for any method will be “affected by the completeness and accuracy of the data used and the reliability of the assumptions made.”53 One way to ensure that results are reliable, is to compare the results achieved under different methods. If two methods produce varying results and the “best method” is not ascertainable, then the

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50 Reg. §1.482-1(c)(1)
51 Reg. §1.482-1(c)(1)
52 Reg. §1.482-1(c)(2)
53 Reg. §1.482-3(b)(2)(iii)
results of other methods may be analyzed to determine if any produce similar results. If two additional methods are applied and both agree with one of the methods previously applied, then those results would be considered more reliable.

1. **Comparable uncontrolled price method (CUP)**

   The regulations state that the comparable uncontrolled price method will normally produce more reliable results than the other methods because this method is generally susceptible to fewer differences between the transactions being compared.\(^{54}\)

   In the comparable uncontrolled price method (referred to as the comparable uncontrolled transaction method when applied to intangibles) the "amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction."\(^{55}\) For tangible property, adjustments may be made to reach comparability, but such adjustments are not available for transfers of intangible property. The largest determinant of comparability under this method is similarity of products.\(^ {56}\) Above, several examples of factors that may be considered in determining similarity between controlled and uncontrolled transactions were given. The factors that are most relevant to the comparable uncontrolled price method for tangible property include: (1) Quality of the product; (2) Contractual terms; (3) Level of the market; (4) Geographic market; (5) Date of transaction; (6) Intangible property associated with the sale; (7) Foreign currency risks; and, (8) Alternatives realistically available to the buyer and seller.\(^ {57}\) These factors differ from those that become important in the comparable uncontrolled transaction

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\(^{54}\) Reg. §1.482-1(c)(2)(i)

\(^{55}\) Reg. §1.482-3(b)(1)

\(^{56}\) Reg. §1.482-3(b)(2)(ii)(A)

\(^{57}\) Reg. §1.482-3(b)(2)(ii)(B)
method. For intangible items, (1) Terms of the transfer; (2) Stage of development of intangible; (4) Economic and product liability risks; and, (5) Function to be performed by the transferor and transferee are most relevant. In addition, to establish comparability, the transfer of an intangible should be associated with a particular product or process.

Following is an example of the comparable uncontrolled price method:

A foreign manufacturer transfers a brand name shoe to a controlled taxpayer in the U.S. for $35. This transaction will be compared to the transfer of a brand name shoe by a foreign manufacturer to an uncontrolled taxpayer for $20. Assuming that no adjustments are necessary to create comparability, then the controlled transaction is not arm’s length and adjustments will be made under §482.

2. Resale Price Method

The resale price method considers gross profit margin in the determination of an arm’s length charge. This method is “ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale.” This method is not commonly used with intangible property.

The actual calculation involved in this method involves “subtracting the appropriate gross profit from the applicable resale price.” The appropriate gross profit is the proper resale price multiplied by the gross profit margin. The proper resale price is the one at which the product is ultimately sold to an uncontrolled party. In other words, intermediate

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58 Reg. §1.482-4(c)(2)(iii)(B)(2)
59 Reg. §1.482-3(c)(1)
60 Reg. §1.482-3(c)(2)(i)
61 Reg. §1.482-3(c)(2)(iii)
sales of the item to other controlled taxpayers will not be used to establish an arm’s length charge.

Comparability, when using this method, generally focuses on “similarity of functions performed, risks borne, contractual terms [and]...consistency of accounting procedures.”62 This method does not rely as heavily on the similarity of products as the comparable uncontrolled price method does although product differences may indicate functional differences between taxpayers.63 The most important consideration when comparing controlled and uncontrolled transactions using this method is the factors that effect gross profit (for example, cost structures, business experience and management efficiency).64

In some instances, a taxpayer may act as a sales agent who does not take title to the goods being transferred. Under the resale price method, the “commission earned...may be used as the comparable gross profit margin.”65 This allows the determinations of an arm’s length amount just as if the transfer occurred as a sale.

3. Cost Plus Method

The cost plus method looks at gross profit markup to determine whether or not a transaction is at arm’s length. This method is most used “in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.”66 The cost plus method is only applicable to transfers of tangible property. The arm’s length price

62 Reg. §1.482-3(c)(3)(ii)(A)
63 Reg. §1.482-3(c)(3)(ii)(B)
64 Reg. §1.482-3(c)(3)(ii)(B)
65 Reg. §1.482-3(c)(3)(ii)(D)
66 Reg. §1.482-3(d)(1)
is determined by “adding the appropriate gross profit to the controlled taxpayer’s costs of producing the property.”\textsuperscript{67}

For this method, the major concerns in determining comparability are “similarity of functions performed, risks borne and contractual terms.”\textsuperscript{68} As with the resale price method, physical product difference is not important in and of itself, yet it may indicate functional differences that may affect the reliability of comparability. The best way to ensure comparability is to use the gross profit markup that the taxpayer realized from comparable transactions with uncontrolled parties. Factors that should especially be considered when making adjustments for comparability under this method include: (1) Complexity of manufacturing or assembly; (2) Manufacturing, production, and process engineering; and, (3) procurement, purchasing, and inventory control activities.\textsuperscript{69}

An example of the cost plus method follows:

A foreign manufacturer produces an item that it sells to both controlled and uncontrolled taxpayers. The arm’s length price that the foreign manufacturer should charge in its controlled transaction is the cost of making the product plus the gross profit markup realized on the uncontrolled transaction.

4. Comparable Profits Method

Under the comparable uncontrolled profits method, “[t]he 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

\textsuperscript{67} Reg. §1.482-3(d)(2)(i)
\textsuperscript{68} Reg. §1.482-3(d)(3)(ii)
\textsuperscript{69} Reg. §1.482-3(d)(3)(ii)(C)
circumstances.” More specifically, the test is applied to the “[a]mount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable.”

In order to understand the comparable profits method, it is first necessary to define a profit level indicator. “Profit level indicators are ratios that measure relationships between profits and costs.” Some examples of profit level indicators include return on capital (operating profit to operating assets) and other financial ratios (i.e., gross profit to operating expense). Deciding which indicator to use will rely on the nature of the business involved in the transaction as well as the reliability of the information available. A variety of profit level indicators may be chosen as long as they are not reliant solely on internal data. When determining the arm’s length amount, however, only one indicator may be used.

“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.” Once the tested party is ascertained, comparability must be established, as with the other methods. Factors affecting operating profit are the most critical in establishing comparability with this method since such profit is the primary determinant of the arm’s length price. Next, functional comparability should be considered although it is not as relevant under this method as for the resale price or cost methods.

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70 Reg. §1.482-5(a)
71 Reg. §1.482-5(b)(1)
72 Reg. §1.482-5(b)(4)
73 Reg. §1.482-5(b)(4)(iii)
74 Reg. §1.482-5(b)(3)
75 Reg. §1.482-5(b)(2)(i)
76 Reg. §1.482-5(c)(2)(ii)
5. Profit Split Method

Comparable Profit Split Method
The profit split method is used when two taxpayers jointly produce a product and sell it to an outside party. The profit from the transaction is split according to “the relative value of each controlled taxpayer’s contribution to combined operating profit or loss.” Such allocations should reflect “the functions performed, risks assumed, and resources employed by each participant.” An important aspect to note is that a member may realize a loss although the group realizes a profit. As long as the total allocation is 100%, any combination may be employed (i.e., 50/50%, 1/99%, -50/150%).

Comparability under this method is established using the same criteria as for the comparable profits method (see page 26). In addition, the “comparable profit split method may not be used if the combined operating profit of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.” Once comparability is established, profit will be split using “[e]ach uncontrolled taxpayer’s percentage of the combined operating profit or loss.”

Finally, “If the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.”

Residual Profit Split Method
The residual profit split method is also used in instances where taxpayers produce a product jointly. In the residual profit split method, “the first step allocates operating income

77 Reg. §1-482-6(a)
78 Reg. §1-482-6(b)
79 Reg. §1-482-6(c)(2)(ii)(B)(1)
80 Reg. §1-482-6(c)(2)(i)
81 Reg. §1-482-6(c)(2)(ii)(D)
to each party to the controlled transaction to provide a market return for its routine
contributions to the relevant business activity."82 Basically, each party will be allocated an
amount that would be consistent with an uncontrolled transaction before considering
intangibles or other uncommon contributions.

"In cases where such intangibles are present there normally will be an unallocated
residual profit after the allocation of income."83 This residual profit generally should be
divided according to the non-routine contributions that each taxpayer made. Other bases for
the allocation of residual profit may include the value of the intangible or recent
expenditures related to the intangible.

Comparability for the first step of this method relies on the considerations "that are
relevant for...market returns for the routine contributions."84 The second step is based
mostly on internal data and is, therefore, less reliable than results achieved in the first step.

As with the comparable profit split method, "[i]f the data and assumptions are
significantly more reliable with respect to one of the parties than with respect to the others,
a different method, focusing solely on the results of that party, may yield more reliable
results."85

6. Unspecified Methods

Unspecified methods are similar to the “fourth methods’ of the 1968 Regulations
(See page 7). Basically, an unspecified method may be used when none of the methods set
forth in the Regulations are applicable. In any case, “an unspecified method should take

82 Reg. §1-482-6(c)(3)(i)(A)
83 Reg. §1-482-6(c)(3)(i)(B)
84 Reg. §1-482-6(c)(3)(i)(C)
85 Reg. §1-482-6(c)(3)(i)(D)
into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction."  

"An unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction." 

Essentially, this method allows flexibility for the IRS in unusual circumstances.

**Intangible Goods**

In applying any of the methods mentioned above, special emphasis should be placed on the determination of arm's length prices for intangibles - the group of transfers that are the hardest to value. When dealing with transactions involving intangibles, care must be taken to establish who owns the intangible. "If the owner of the rights to exploit an intangible transfers such rights to a controlled taxpayer, the owner must receive an amount of consideration." This consideration should be at arm's length and determined by one of the methods mentioned above. "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 the rights relating to the resale of the tangible property made under normal commercial practice." In this instance, the transfer will be treated as a transfer of tangible property, but the uncontrolled transaction must include an intangible in order to be comparable.

"An intangible 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;

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86 Reg. §1.482-3(e)(1)
87 Reg. §1.482-3(e)(1)
88 Reg. §1.482-4(f)(3)(i)
89 Reg. §1.482-3(f)
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 similar items. \(^90\)

**Conclusion**

The regulations discussed above are the attempt by the Internal Revenue Service to recapture income tax revenues that were being lost due to transfer pricing abuses. "Approximately 72% of foreign-controlled corporations and 59% of U.S.-controlled corporations paid no U.S. income tax between the years 1987 and 1990...As of October 1993, pending disputes of transfer pricing adjustments involved at least $11.3 billion in tax deficiencies."\(^91\) In order to fix these problems, the 1994 final Regulations attempted to create more specific regulations that could be followed by taxpayers. If the regulations were truly going to be enforced, the poor administration and vagueness of the rules had to be eliminated.

Since this set of regulations became effective as of October 1994, only those companies with a fiscal year ending in October or November will have completed a full tax year under the new regulations. To date, sufficient data is not available to determine how the regulations have affected the tax liabilities of multinational companies. If the Regulations have worked according to Congress’ plans, multinational companies’ tax

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\(^{90}\) Reg. §1.482-4(b)

\(^{91}\) 16 University of Pennsylvania Journal of International Business Law 340
liabilities should increase while U.S. income tax revenues increase. Whether or not this objective has been met remains to be seen. The issuance of the final Regulations, however, still increases taxpayers' overall liabilities due to strict reporting requirements. One company estimates that it will spend approximately one million dollars to produce all of the documentation necessary to prove compliance with §482. 92

When information becomes available, further analyses should be done to determine the total effects on taxpayers as well as income tax revenues.

92 16 University of Pennsylvania Journal of International Business Law 365
APPENDIX

Definitions

"Organization includes an organization of any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation."

"Trade or business includes a trade or business activity of any kind."

"Taxpayer means any person, organization, trade, or business, whether or not subject to any internal revenue tax."

"Controlled includes any kind of control, direct or indirect, whether legally enforceable or not."93 "In order to find control, no percentage requirements are specified nor are any precise requirements necessary. The trend in recent case law is to apply the 'realistic approach.' Section 482 'means actual, practical control rather than any particular percentage of stock ownership.'"94

"Controlled taxpayer means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests."

"Uncontrolled taxpayer means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests."

"Group, controlled group, and group of controlled taxpayers mean the taxpayers owned or controlled, directly or indirectly by the same interests."

93 Reg. §1.482-1(i)(1)-(4)
"Transaction means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property or money."

"Controlled transaction or controlled transfer means any transaction or transfer between two or more members of the same group of controlled taxpayers."

"True taxable income means the taxable income that would have resulted had it dealt with the other member or members of the group at arm’s length."

"Uncontrolled comparable means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methods."\textsuperscript{95} \[95 \text{Reg. } \S 1.482-1(i)(5)-(10)\]

"Sales revenue means the amount of the total receipts from sales goods and provision of services, less returns and allowances."

"Gross profit means sales revenue less cost of goods sold."

"Operating expense includes all expenses not included in cost of goods sold except for interest expense, foreign income taxes, domestic income taxes, and any other expense not related to the operation of the relevant business activity."

"Operating profit means gross profit less operating expenses."

"Reported operating profit means the operating profit of the tested party reflected on a timely filed U.S. income tax return."

"Operating assets means the value of all assets used in the relevant business activity of the tested party, including fixed assets and current assets."\textsuperscript{96} \[96 \text{Reg. } \S 1.482-5(d)(1)-(6)\]
Bibliography


