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U.S. Final Transfer Pricing Regulations

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U.S. Final Transfer Pricing Regulations

JOHN S. NOLAN*

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The § 482 regulations, as adopted on July 1, 1994,¹ represent the culmination of six years of intense controversy arising out of the Treasury White Paper.² During this period, the corporate tax community, other governments, and the Internal Revenue Service debated at length provisions of the 1992 proposed regulations³ and the 1993 temporary regulations⁴ in order to implement the exceedingly brief rule in § 482 of the Internal Revenue Code of 1986.⁵

The new regulations are extraordinarily long and complex,⁶ but they represent only part of the IRS effort to address the transfer pricing dilemma. Equally important, as a practical matter, are fearsome new transfer pricing penalty regulations that implement §§ 6662(e) and (h) and 6664(c) of the Internal Revenue Code.⁷ These penalty regulations impose severe analytical burdens, recordkeeping obligations, and documentation requirements as conditions for avoiding extremely severe penalties.

* Miller & Chevalier, Chartered, Washington, D.C. University of Miami School of Law International Tax Institute, February 14-16, 1996.

1. T.D. 8552, 1994-2 C.B. 93.

2. I.R.S. Notice 88-123, 1988-2 C.B. 458.

3. 57 Fed. Reg. 3571 (1992).

4. 58 Fed. Reg. 5263 (1993).

5. I.R.C. § 482 Allocation of income and deductions among taxpayers, 13 CCH Fed. Tax Serv. 4121 (1996) (In the CCH text, the entire provision is set forth in only 14 lines.).

6. See *id.* (discussing the § 482 regulations). The CCH version covers 60 pages of double-column small print, ranging from Treas. Reg. § 1.482-0 (Outline) to a set of general rules (§ 1.482-1), specific rules for cases involving loans or advances, services, and use of tangible property (§ 1.482-2), transfer of tangible property (§ 1.482-3), transfer of intangible property (§ 1.482-4), the comparable profits method (§ 1.482-5), the profit-split methods (§ 1.482-6), cost sharing (§ 1.482-7) issued December 20, 1995 (60 Fed. Reg. 65553 (1995), and examples of the best method rule (§ 1.482-8).

7. T.D. 8519, 1994-1 C.B. 298.

The Service has undertaken an innovative, and thus far largely successful, Advance Pricing Agreement ("APA") program to provide an alternative to the penalty risks that will inevitably arise out of these complex and controversial rules. Unfortunately, the costs and risk of seeking an APA are quite substantial. Seeking an APA, however, is surely the safest route for large U.S. businesses with extensive international operations and foreign companies doing business in the United States.

In the final 1994 § 482 regulations the Service has adopted the key White Paper conclusion that taxpayers should be required to develop and document methodology used to establish transfer prices prior to filing their tax return. They must reflect those prices on a timely filed return and provide documentation to the Service promptly on request.⁸ The Service has implemented a series of broad, ongoing international tax enforcement programs to force taxpayers with international related party transactions to accept and follow these requirements in order to avoid penalties.

Understanding the interrelationship between the new transfer pricing regulations and the new penalty regulations is the key to realizing the impact of the new transfer pricing regulations. The heart of these regulations is contained in the general rules of Treasury Regulation § 1.482-1, which will be summarized first in this paper. Next, the penalty regulations will be summarized in order to describe this critical interrelationship. Finally, this paper will briefly review the application of the general rules with respect to each of the specified methods in light of the penalty risks.

I. GENERAL RULES—TREASURY REGULATION § 1.482-1

One-Way Street. The regulations restate clearly and emphatically that the taxpayer must report on a timely filed return the results of its controlled transactions to reflect an arm's length result, regardless of the price actually charged. As under prior law, § 482 is a one-way street; the Service can adjust the taxpayer's return to reflect arm's length results, but the taxpayer cannot file an untimely or amended return to decrease taxable income on that basis.⁹

Best Method Rule. The single most important concept in the new regulations is the "best method rule," defined as the method that provides the "most reliable measure of an arm's length result" based gener-

8. I.R.S. Notice 88-123, 1988-2 C.B. 458, 464-65.

9. Treas. Reg. § 1.482-1(a)(3) (The provision uses the word "may" but the context indicates that the purpose is to allow the taxpayer to file an amended return, thereby voluntarily to increasing taxable income to reflect an arm's length price, in an attempt to show good faith and avoid a penalty.).

ally on the results of transactions between unrelated parties.¹⁰ There is no longer any "strict priority of methods," but a preference still exists for the comparable uncontrolled price method ("CUP"). Additionally, the resale price method ("RPM") is still preferred for distribution businesses, and the cost plus method ("CPM") for manufacturing activities.¹¹ Where two or more methods may provide such a result, the choice will depend primarily on two factors: the degree of comparability and reliability, including the quality of the data and assumptions used.¹²

Comparability. Comparability need not be identical but must be sufficiently similar to provide the required "reliable measure." If material differences exist between the controlled and uncontrolled transactions, adjustments are to be made "if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results."¹³ "If adjustments for material differences cannot be made, the uncontrolled transaction may [still] be used as a measure of an arm's length result, but the reliability of the analysis will be reduced."¹⁴ Unadjusted industry average returns cannot be used to establish arm's length results."¹⁵

Reliability. Reliability of uncontrolled data for this purpose depends on its completeness and accuracy, the reliability of the assumptions used, and the sensitivity of the results to possible deficiencies in the data and assumptions.¹⁶ More complete and accurate data permit identification of differences between the controlled and uncontrolled data and enhance the reliability of adjustments to account for such differences.¹⁷ Assumptions have varying degrees of reliability. For example, differences in payment terms can be adjusted to reflect the time value of money.¹⁸ On the other hand, the "profit split method may be based on the [sensitive and subjective] assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party" and "the soundness of this assumption will affect the reliability of the results of this method."¹⁹

The reliability of certain methods is heavily dependent on the similarity of the property or services involved. For other methods, such as the resale price method, the similarity of functions performed, resources

10. Treas. Reg. § 1.482-1(c)(1) (1994).

11. *Id.*; Treas. Reg. §§ 1.482-1, 1.482-8 ex. 1, 2, 3 and 5.

12. *Id.* § 1.482-1(c)(2).

13. *Id.* § 1.482-1(d)(2).

14. *Id.*

15. *Id.*

16. *Id.* § 1.482-1(c)(2)(ii).

17. *Id.* § 1.482-1(c)(2)(ii)(A).

18. *Id.* § 1.482-1(c)(2)(ii)(B).

19. *Id.*

utilized, and risks borne is more important. For the profit split method, definition of the relevant business activity and proper allocation of costs, income, and assets are of particular importance. Differences in management efficiency may have a greater effect on the CPM than on the CUP. Differences in product will have a greater effect on a CUP method than on a CPM method.²⁰

Should two or more methods produce inconsistent results, and the best method rule does not indicate which is most reliable, results obtained by still another method may be considered to determine which of the competing methods appears most reliable.²¹

Comparability Factors. Comparability depends on all factors that could affect prices or profits in arm's length dealings. Comparability factors include functions performed and associated resources employed (functional analysis), contractual terms, risks, economic conditions, and the nature of the property or services involved.²² Functional analysis requires identification and comparison of economically significant activities undertaken. Resources employed include the type of assets used—plant and equipment, or valuable intangibles, or both. Functions to be considered include: research and development, product design and engineering, manufacturing and process engineering, product fabrication and assembly, purchasing and materials management, marketing and distribution functions (including inventory management, warranty administration, and advertising), transportation and warehousing, and managerial and related services.²³

Contractual Terms. Contractual terms relevant in assessing the reliability of the comparison include the form of consideration paid, sales or purchase volume, warranties provided, rights to modifications, the duration of relevant licenses or other agreements, and termination or renegotiation rights, collateral relationships between the buyer and seller, such as provision of ancillary services, and extension of credit and payment terms.²⁴

Contractual terms in existence beforehand will be respected if consistent with the economic substance.²⁵ "In the absence of a written agreement, the [Service] may impute a contractual agreement" based on the economic substance of the transaction.²⁶ If a U.S. distributor of a foreign parent has borne the marketing costs of building up the parent's

20. *Id.* § 1.482-1(c)(2)(ii)(C).

21. *Id.* § 1.482-1(c)(2)(iii).

22. *Id.* § 1.482-1(d)(1).

23. *Id.* § 1.482-1(d)(3)(i).

24. *Id.* § 1.482-1(d)(3)(ii)(A).

25. *Id.* § 1.482-1(d)(3)(ii)(B)(1).

26. *Id.* § 1.482-1(d)(3)(ii)(B)(2).

trade name in the United States to a degree substantially above what an uncontrolled distributor would incur, the controlled U.S. distributor must be allocated the profit element attributable to the tradename. Established industry conventions will be followed if the conduct of the controlled parties is consistent with such practices.²⁷

Risk. Relevant degrees of risk to be compared include market risks (fluctuations in cost, demand, pricing, inventory levels), success or failure of research and development activities, financial and foreign currency risks (interest rates, exchange rates), credit and collection risks, product liability risks, and general business risks as to ownership of plant, property, and equipment.²⁸ In considering the economic substance of risk allocation by contractual agreements, the pattern of conduct of the controlled parties will be considered as to consistency with such agreements. The financial capacity of a controlled party to assume any such risk will be considered. Finally, the extent to which a controlled party nominally bearing a risk has managerial or operational control over the business activities resulting in the risk is relevant because “[i]n arm’s length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.”²⁹

Economic Conditions. The extent to which controlled and uncontrolled transactions are comparable requires consideration of the relative economic conditions under which each such set operates. These include similarity of geographical markets; the size and degree of development in each market; the market level—manufacturing, wholesale, retail; the comparative market shares of the relevant parties; the location-specific costs of the factors of production and distribution; the extent of competition in the compared markets; the economic conditions of the particular industry, including whether the market is expanding or contracting; and “[t]he alternatives realistically available to the buyer and seller.”³⁰ The final factor above refers to a “make or buy” type decision.

Property or Services. This final factor of comparability emphasizes the need to consider “intangibles that are embedded in tangible property or services being transferred.”³¹ This in turn invokes the extensive, separate provisions of the regulations dealing with transfers of intangible property.³²

Special Circumstances. The regulations deal with three special cases. A market share strategy may be used by a controlled party to

27. *Id.* § 1.482-1(d)(3)(ii)(C) ex. 3.

28. *Id.* § 1.482-1(d)(3)(iii)(A).

29. *Id.* § 1.482-1(d)(3)(iii)(B).

30. *Id.* § 1.482-1(d)(3)(iv).

31. *Id.* § 1.482-1(d)(3)(v).

32. *Id.* § 1.482-4(c)(2)(iii)(B)(1).

enter a new market or to increase the taxpayer's share of an existing market. This will reflect increased market development costs or prices lower than prices for comparable products in the same market. Such a strategy will be respected only "if it can be shown that an uncontrolled taxpayer engaged in a comparable strategy under comparable circumstances for a comparable period of time." Further, the taxpayer must provide documentation that supports this strategy. The documentation must substantiate that "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." It must also show that "the strategy [was] pursued only for a period of time that is reasonable, taking into consideration the industry and product in question."³³

Where the only uncontrolled comparables available are those in a different geographical market, adjustments must be made to account for differences in the two markets.³⁴ Significant factors include substantial differences in costs in the two markets—the so-called "location savings." For example, lower labor costs in a controlled manufacturer's geographic market will justify higher profits in that market "only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length . . . in that market."³⁵

Arm's Length Range. This important determination is made by applying a single pricing method selected under the best method rules (CUP, RPM, cost plus, CPM, or profit split) to two or more uncontrolled transactions of similar comparability and reliability.³⁶ A taxpayer whose results fall within an arm's length range will not be subject to an IRS adjustment (if such a range can be established).³⁷

To create such a range, ideally the information on the controlled transaction and the uncontrolled comparables must be 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."³⁸ If this test cannot be satisfied, the range is established from those uncontrolled comparables that can thereby be brought to a similar level of comparability and reliability. This requires adjustments for differences to the extent the effect on price or profit can be ascertained with reasonable accuracy, to improve the reliability of the results. Further, the range so created must be adjusted by a "valid statis-

33. *Id.* § 1.482-1(d)(4)(i).

34. *Id.* § 1.482-1(d)(4)(ii)(A).

35. *Id.* § 1.482-1(d)(4)(ii)(C).

36. *Id.* § 1.482-1(e)(2)(i).

37. *Id.* § 1.482-1(e)(1).

38. *Id.* § 1.482-1(e)(2)(iii)(A).

tical method" to increase its reliability. It must be sufficiently reliable to achieve a seventy-five percent probability of a result falling above the lower end of the range and an equal probability of a result falling below the upper end of the range.³⁹

If the controlled transaction falls outside the arm's length range, an IRS adjustment may be made to any point within that range. If the interquartile type range has had to be constructed, the adjustment will ordinarily be to the median, not the mean of the range. In other cases, the adjustment will be to the mean.⁴⁰

Scope of Review. The regulations restate the prior well-established rule that intent to evade or avoid tax is not a prerequisite to an IRS adjustment.⁴¹ Thus, § 482 by its terms authorizes the Service to adjust the income of controlled organizations to reflect their income clearly, regardless of a tax avoidance motive. Similarly, the new regulations make it clear that the Service adjustment is not limited to income realized by the controlled group as a whole within the taxable year.⁴² The adjustment, for example, can result in a loss to one controlled party, or can involve a restatement of the allocable shares of the controlled parties in an overall loss in dealings with uncontrolled parties. Finally, the non-recognition provisions of the Code do not block an IRS adjustment; for example, basis following a § 351 transfer can be adjusted to reflect the value of the asset when it was transferred to a controlled subsidiary if lower than its original cost to the transferor.⁴³

Aggregation of Transactions. The combined effect of two or more separate transactions may be considered if this is the most reliable means of determining the proper transfer price.⁴⁴ Thus, if P licenses S-1 to use a proprietary manufacturing process, and S-1 sells to S-2, which sells to uncontrolled parties, it "may be appropriate" to consider the combined profit of S-1 and S-2 in comparing the profit realized by P from the license to S-1. This may allow the controlled group to structure its operations to avoid foreign tax, as where S-1 or S-2 operates in a low tax country, so long as the U.S. parent (P) realizes an arm's length share of the total profit from manufacture and sale of the end product.⁴⁵

Alternatives Available (Make or Buy). The Service is specifically authorized to consider alternatives available to the controlled taxpayer that an uncontrolled taxpayer might adopt if operating under the same

39. *Id.* § 1.482-1(e)(2)(iii)(B).

40. *Id.* § 1.482-1(e)(3).

41. *Id.* § 1.482-1(f)(1)(i).

42. *Id.* § 1.482-1(f)(1)(ii).

43. *Id.* § 1.482-1(f)(1)(iii).

44. *Id.* § 1.482-1(f)(2)(i)(A).

45. *Id.* § 1.482-1(f)(2)(i)(B) ex. 1.

conditions.⁴⁶ The fact that P could have manufactured a product and sold it to S-1 for resale outside the U.S., instead of licensing S-1 to use P's proprietary manufacturing process to manufacture and sell the product abroad, may be taken into account.⁴⁷

Multiple Year Data. Ordinarily, the necessary comparison is to be made to uncontrolled comparables for the year for which the uncontrolled taxpayer's results are being audited. Multiple year data for the same multiple year period of the uncontrolled and controlled parties may be considered, however, if available, and if same-year data comparison is not possible.⁴⁸ Such data may also be considered if the effect of business cycles on the controlled taxpayer is relevant, or if life cycles of the product or intangible being considered are relevant.⁴⁹

Multiple year data will ordinarily be considered in comparing the risk factor, the market share factor, the periodic adjustments provision for intangibles pursuant to the "commensurate with the income" rule in § 482, and generally in the application of the CPM. Multiple year data ordinarily will not be considered in applying the CUP method except to the extent risk or market share strategy issues exist.⁵⁰

Multiple year data may also be considered in order to reduce the effect of short-term variations in comparing a controlled taxpayer's average result over a period of years with average results of uncontrolled taxpayers.⁵¹

Product Lines and Statistical Techniques. This important set of rules is a bow to reality, recognizing that a U.S. taxpayer may have many different products and many separate transactions involving the same product. Arm's length results may be determined by reference to overall results for product lines or other groupings. Sampling and other "valid statistical techniques" may also be used.⁵²

Collateral Adjustments. The Service must make correlative allocations to reflect the effect of a § 482 adjustment as to all other members of the controlled group.⁵³ Thus, for example, the adjustment may affect the earnings and profits of a foreign subsidiary and thus possibly have Subpart F or foreign tax credit effects. The Service must give the taxpayer a written statement of the amount and nature of such correlative allocations. This IRS statement must then be reflected in the documen-

46. *Id.* § 1.482-1(f)(2)(ii)(A); Treas. Reg. § 1.482-4(d)(2).

47. *Id.* § 1.482-1(f)(2)(ii)(B).

48. *Id.* § 1.482-1(f)(2)(iii)(A).

49. *Id.* § 1.482-1(f)(2)(iii)(B).

50. *Id.*

51. *Id.* § 1.482-1(f)(2)(iii)(D).

52. *Id.* § 1.482-1(f)(2)(iv).

53. *Id.* § 1.482-1(g)(2)(i).

tation of the other member or members maintained for U.S. tax purposes.⁵⁴

Similarly, conforming adjustments must be made, such as treating a § 482 adjustment as a dividend or capital contribution.⁵⁵ The regulations incorporate Rev. Proc. 65-17, 1965-1 C.B. 833, permitting repayment of an allocated amount without further U.S. tax consequences.⁵⁶

Finally, the regulations allow for set-offs for the effect of any other non-arm's length transaction between the same controlled taxpayers in the same taxable year.⁵⁷ This is permitted, however, only if the taxpayer documents all correlative adjustments resulting from the proposed set-off and notifies the Service within thirty days of receiving a notice of the proposed adjustment against which the set-off is to be made.⁵⁸ If the set-off otherwise distorts taxable income so as to affect U.S. tax liability, those distortions will be corrected.⁵⁹

Small Taxpayer Safe Harbor. The 1993 proposed regulations⁶⁰ included a safe harbor rule for small transactions, but it has not been retained in the final regulations. Nevertheless, the current regulations reserve a place for such a rule should it later be developed.⁶¹

Effect of Foreign Legal Restrictions. The regulations attempt to limit severely the effect of recent court decisions rejecting § 482 adjustments deemed to be prevented by foreign legal restrictions.⁶² Such restrictions will be taken into account only if it is shown that they "affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time."⁶³ In the absence of such evidence, the restriction will be taken into account only if it has been publicly promulgated; is generally applicable to both controlled and uncontrolled parties; and is not imposed as part of a commercial transaction between the taxpayer and the foreign sovereign. Also, the taxpayer must have exhausted all remedies for obtaining a waiver, and the restriction must have expressly prevented the payment or receipt in any form of part or all of the arm's length amount. Finally, the related parties must not have circumvented the restriction, or otherwise violated it, by arrangements

54. *Id.* § 1.482-1(g)(2)(ii).

55. *Id.* § 1.482-1(g)(3)(i).

56. *See id.* § 1.482-1(g)(3)(ii).

57. *Id.* § 1.482-1(g)(4)(i).

58. *Id.* § 1.482-1(g)(4)(ii).

59. *Id.* § 1.482-1(g)(4)(i).

60. 58 Fed. Reg. 5263 (1993).

61. Treas. Reg. § 1.482-1(h)(1) (1994).

62. *Procter & Gamble Co. v. Commissioner*, 95 T.C. 323 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992); *Exxon Corp. v. Commissioner*, 66 T.C.M. (CCH) 1707 (1993).

63. Treas. Reg. § 1.482-1(h)(2)(i) (1994).

with controlled or uncontrolled parties.⁶⁴

These limitations seek to reverse the effect of the decisions in the *Proctor & Gamble* and *Exxon* cases. The Spanish legal restriction in *Proctor & Gamble* only affected transactions between a Spanish affiliate and its parent company. The Saudi Arabian restriction in *Exxon* probably would not have met the public proclamation and exhaustion of remedies test. According to the Service's position, the effect of the Saudi price limitation was circumvented by downstream transactions.

The new regulations provide further that where a foreign legal restriction prevents payment under all of the foregoing conditions, the taxpayer may elect to use a "deferred income method of accounting," in which case the arm's length amount, to the extent not paid, will be deferred until payment or receipt is no longer prevented.⁶⁵ This is quite a different result than the holding in those cases that there could be no § 482 adjustment because of foreign legal restrictions.⁶⁶

The mere fact that a foreign legal restriction prevents deduction of an amount for foreign tax purposes is not a restriction preventing payment and thus will have no effect on a § 482 adjustment by the Service.

II. THE PENALTY REGULATIONS—TREASURY REGULATION § 1.6662-6T

The penalty regulations must be considered against the background of the general rules of § 482. The general rules depend upon such uncertain concepts as "reliability," "degree of comparability," "material differences," "completeness and accuracy" of data, "functional analysis," "management efficiency," "business experience," "economic substance," "embedded intangibles," "valid statistical method," "realistic alternatives," and others.

Similarly, as previously described, to avoid an IRS adjustment, the taxpayer must select and apply the "best method." In creating an arm's length range, a critical step must be addressed: uncontrolled comparables must be classified as between those that have, or can be adjusted to provide, a similar level of comparability and reliability, as distinguished from those that have a significantly lower level of these characteristics.⁶⁷

An issue may develop as to whether the economic substance of a transaction, or the course of conduct of a party, differs from the contractual terms of the agreement between the related parties. Are these

64. *Id.* § 1.482-1(h)(2)(ii).

65. *Id.* § 1.482-1(h)(2)(iii).

66. *See supra* note 62.

67. *See supra* note 39.

highly-subjective issues an appropriate framework for imposing severe penalties for “noncompliance”?

The Potential Penalties. Section 1.6662-6T(b)(1) imposes a twenty percent “substantial valuation misstatement” penalty based on the underpayment of tax due to a § 482 adjustment in either of two circumstances. First, the penalty applies if the transfer price for any property or services in connection with a 482 transaction is two hundred percent or more, or fifty percent or less, of the correct amount determined under § 482.⁶⁸ Alternatively, it applies if the net § 482 price adjustment for the taxable year exceeds the lesser of five million dollars or ten percent of the taxpayer’s gross receipts.⁶⁹

The two hundred percent or more rule basically relates to inbound transactions in which the transfer price is too high from the standpoint of the United States, and the fifty percent or less rule applies to outbound transactions in which the price is too low.

The penalty is increased to forty percent if there is a “gross valuation misstatement,”⁷⁰ which occurs if the price is four hundred percent or more, or twenty five percent or less, of the correct amount determined under § 482,⁷¹ or if the net § 482 price adjustment for the taxable year exceeds the lesser of twenty million dollars or twenty percent of the taxpayer’s gross receipts.⁷²

No penalty is imposed if the underpayment of tax attributable to the § 482 adjustment is five thousand dollars or less (ten thousand in the case of a C corporation or a personal holding company).

The two hundred percent/fifty percent, four hundred percent/twenty five percent, set of penalties is referred to in the penalty regulations as the “transactional penalty.” The set of penalties based on the § 482 adjustment exceeding the lesser of five million dollars or ten percent of the taxpayer’s gross receipts, or the lesser of twenty million dollars or twenty percent of gross receipts, is referred to as the “net adjustment penalty.”⁷³

Avoiding the § 482 Penalty. No penalty is imposed if it is established that—(1) the taxpayer determined the transfer prices pursuant to a specified method in the § 482 regulations and the use of such method was reasonable;⁷⁴ (2) the taxpayer has documentation (in existence at the time of filing the return) setting forth the determination of the price pur-

68. Temp. Treas. Reg. § 1.6662-6T(b)(1) (1994).

69. *Id.* § 1.6662-6T(c)(2).

70. *Id.* § 1.6662-6T(a)(1).

71. *Id.* § 1.6662-6T(b)(2).

72. *Id.* § 1.6662-6T(c)(3).

73. *Id.* § 1.6662-6T(a)(1).

74. *Id.* § 1.6662-6T(d)(2)(ii).

suant to such a method and establishing that the use of the method was reasonable; and (3) the taxpayer provides such documentation to the Service within thirty days of a request for it.⁷⁵

Further, no penalty is imposed even if the price was not determined pursuant to a specified method if the taxpayer establishes that—(a) none of the specified methods was likely to clearly reflect income, and the taxpayer used another method that was likely to clearly reflect income;⁷⁶ and (b) the taxpayer satisfies the same documentation and production requirements set forth in (2) and (3) above.⁷⁷

Finally, no penalty is imposed if the § 482 adjustment affects only foreign corporations and does not affect U.S. source or effectively connected income.⁷⁸

The taxpayer cannot satisfy the reasonable cause exception with respect to the net adjustment penalty except by meeting the three conditions set forth in the third preceding paragraph. The taxpayer can, however, satisfy the reasonable cause exception with respect to the transactional penalty by meeting the far less stringent, general reasonable cause exception provided in Treasury Regulation § 1.6664-4. This latter exception is available, however, only if the § 482 adjustment subjects the taxpayer to the transactional penalty and not to the net adjustment penalty.

The Documentation Requirements. The temporary penalty regulations reflect the IRS determination to force contemporaneous, detailed, documented explanations by taxpayers regarding their transfer pricing methodology. These regulations take the analysis and documentation requirements to a new compliance level that large taxpayers with extensive and complex related party dealings may not be able to achieve. These documentation requirements go beyond the documentation of what the taxpayer has actually done in establishing transfer prices; they effectively require the accumulation of tutorial information as to the taxpayer's business.

Reported Results. The penalty regulations, consistent with the § 482 regulations, further establish the critical importance, indeed necessity, of complete analysis and documentation before the return is filed or, in certain cases, at least before the Service commences an audit. Thus, in determining whether a penalty applies, an amended return will be taken into account only if filed before the Service contacts the taxpayer as to the original return. A written statement furnished at the

75. *Id.* § 1.6662-6T(d)(2)(iii)(A).

76. *Id.* § 1.6662-6T(d)(3)(ii)(B).

77. *Id.* § 1.6662-6T(d)(3)(iii)(A).

78. *Id.* § 1.6662-6T(d)(4).

beginning of a Coordinated Examination Program audit for a large corporation will be accepted for this purpose.

Specified Method Exception. This exception to the penalty will apply only if "given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best methods rule"⁷⁹ Moreover, the taxpayer must have evaluated the potential applicability of the other specified methods.⁸⁰ The determination whether the taxpayer's conclusion was reasonable will be a facts and circumstances inquiry, based on four factors: (1) the experience and knowledge of the taxpayer, including all members of the taxpayer's controlled group; (2) the extent to which accurate data were available following a reasonably thorough search by the taxpayer, and that the data were analyzed in a reasonable manner; (3) the extent to which the taxpayer followed the § 482 regulations as to application of the method; and (4) the extent to which the taxpayer reasonably relied upon a qualified professional.⁸¹

Principal Documents. In addition, the taxpayer must have maintained sufficient documentation at the time the return was filed to substantiate the best method selection. The documentation is divided into several categories. "Principal documents" must accurately and completely describe the basic transfer pricing analysis by the taxpayer. They must include:

- an overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;
- an organizational structure description, covering all related parties engaged in transactions potentially relevant under § 482, including foreign affiliates;
- documents required by the § 482 regulations;
- a description of the method selected and why it was chosen;
- a description of alternative methods considered and why they were not selected;
- a description of the controlled transaction and internal data used to analyze them;
- a description of comparables used, how comparability was evaluated, and what adjustments were made;
- an explanation of the economic analysis and projections relied upon in developing the method; and
- a general index of principal and background documents and a

79. *Id.* § 1.6662-6T(d)(2)(ii).

80. *Id.*

81. *Id.* § 1.6662-6T(d)(2)(ii).

description of the recordkeeping system used for cataloging and accessing those documents.⁸²

"Background documents" are materials supporting the principal documents.⁸³ "Tax return documentation" includes statements required to be filed with a timely filed return, as where a profit split method is used, or where the consideration for a transfer of an intangible between controlled parties consists of a lump sum payment.⁸⁴

The method inquiry depends upon whether a specified method was or was not potentially applicable. If an unspecified method is used, the taxpayer must have reasonably concluded, given the available data, that none of the specified methods was likely to provide a reliable measure of an arm's length result, and that the unspecified method selected was more likely to provide a reliable result.⁸⁵ The taxpayer must have made a reasonable effort to evaluate the use of specified methods pursuant to the best method rule. Reasonableness will depend on the same four "facts and circumstances" factors previously described.⁸⁶

If the taxpayer applies an unspecified method, a statement must be attached to a timely filed return disclosing the use of such method.⁸⁷

Reasonable Cause Exception to Transactional Penalty. The reasonable cause-good faith exception to a transactional penalty that does not also qualify as a net adjustment penalty is far less rigid.⁸⁸ The taxpayer need only have made a reasonable effort to comply. Reliance on a qualified professional is likely, by itself, to support a finding of reasonableness.

Conclusions as to Penalty Regulations. The principal penalty threat to most large corporate taxpayers will be the net adjustment penalty of forty percent where the § 482 adjustment exceeds the lesser of twenty million dollars or twenty percent of the taxpayer's gross receipts. This is a horrendous risk. The twenty million dollar threshold is extremely low, given the volume of international business of major U.S. companies doing business abroad and major foreign companies doing business in the United States.

The specified method exception depends upon the highly subjective and uncertain question whether the taxpayer's methodology was reasonably calculated to provide the most reliable arm's length result. The four-factor analysis, except possibly for reliance on a qualified profes-

82. *Id.* § 1.6662-6T(d)(2)(iii)(B).

83. *Id.* § 1.6662-6T(d)(2)(iii)(C).

84. *Id.* § 1.6662-6T(d)(2)(iii)(D).

85. *Id.* § 1.6662-6T(d)(3)(ii)(B).

86. *Id.* § 1.6662-6T(d)(3)(ii)(C).

87. *Id.* §§ 1.6662-6T(d)(3)(iii)(C).

88. *Id.* § 1.6662-6T(c)(6).

sional, is equally subjective and uncertain. The documentation requirements are extensive and quite controversial, while the use of an unspecified method will create even greater risks.

Much will depend upon whether the Service can and will maintain a uniform, reasonable policy in administering these penalties. If the Service does not, the courts may develop policies to achieve a reasonable balance. This is uncertain, however, and will not necessarily yield consistent treatment. The Service is more likely to achieve its objective of more accurate self-assessment by following a policy of moderation, encouragement, and cooperation rather than by imposing such severe punishment.

III. LOANS/SERVICES/USE OF TANGIBLE PROPERTY—TREASURY REGULATION § 1.482-2

Intercompany Loans. In general, intercompany loans between controlled parties must provide for interest at an arm's length rate, defined by reference to the Applicable Federal Rate ("AFR") determined under Code § 1274.⁸⁹

Interest need not be paid on intercompany trade receivables until the first day of the third calendar month following the month in which the intercompany trade receivable arises (or the fourth calendar month for a debtor member located outside the U.S.).⁹⁰ Further, if the related parties are operating in an industry in which unrelated parties, as a regular trade practice, provide trade credit for a longer period, such longer period may be used.⁹¹

Another exception permits a longer period for intercompany trade receivables arising from a purchase of property by one member from another member, for resale to unrelated persons, in a particular foreign country in which the related party selling member also sells to unrelated parties on longer credit terms. The interest-free period in such case may be based on the number of days of the related purchaser's average collection period for sales of property (within the same product group) to unrelated persons in the same foreign country in the ordinary course of business.⁹² The average collection period is determined by the relationship of—(1) the related purchaser's sales in the same product group to unrelated persons in the same foreign country in the preceding taxable year, to (2) the related purchaser's average month-end accounts receiva-

89. Treas. Reg. § 1.482-2(a)(2)(iii)(B).

90. *Id.* § 1.482-2(a)(1)(iii)(B).

91. *Id.* § 1.482-2(a)(1)(iii)(D).

92. *Id.* § 1.482-2(a)(1)(iii)(E)(1).

ble balance with respect to such sales for such preceding year.⁹³ Such interest-free period may not exceed 183 days.⁹⁴

An arm's length interest rate is the rate charged in independent transactions with or between unrelated parties under similar circumstances.⁹⁵ The arm's length rate will be used if the loan represents the proceeds of a loan obtained from an unrelated party by the related lender at the situs of the related borrower. The interest rate is then increased by an amount reflecting the costs incurred by the lender in borrowing such amounts.⁹⁶ Except as provided in the preceding sentence, however, an arm's length interest rate is deemed to be the rate actually charged if it is not less than one hundred percent of the AFR ("lower limit") and not greater than one hundred and thirty percent of the AFR ("upper limit"). If no interest is charged, or the rate is less than the lower limit, the arm's length rate is deemed to be the lower limit, compounded semiannually. If the interest rate actually charged on the intercompany loan exceeds the upper limit, the arm's length rate is deemed to equal the upper limit, compounded semiannually, unless the taxpayer establishes a more appropriate compound rate.⁹⁷

If the related lender is regularly engaged in the business of making loans to unrelated parties, the AFR rates may not be used. The rate must be determined under the general arm's length standard.⁹⁸ Similarly, if the loan is expressed in a foreign currency, the AFR rates may not be used.⁹⁹

The regulation contains rules for coordination with the provisions of Internal Revenue Code §§ 467, 483, 1274, and 7872, which also address interest adjustments.¹⁰⁰

Intercompany Services. If intercompany services are provided at no charge or a charge which differs from an arm's length charge, the Service will make an adjustment to reflect the "relative benefits intended from the services," whether or not actually realized.¹⁰¹ However, no adjustment will be made if the probable benefits were so indirect or remote that unrelated parties would not have changed for such services (as where an international airline flies to cities in which a related company owns and operates hotels, but does not mention or picture the

93. *Id.* § 1.482-2(a)(1)(iii)(E)(3).

94. *Id.* § 1.482-2(a)(1)(iii)(E)(2).

95. *Id.* § 1.482-2(a)(2)(i).

96. *Id.* § 1.482-2(a)(2)(iii)(B)(3).

97. *Id.*

98. *Id.* § 1.482-2(a)(2)(iii)(D).

99. *Id.* § 1.482-2(a)(2)(iii)(E).

100. *Id.* § 1.482-2(a)(3).

101. *Id.* § 1.482-2(b)(2).

hotels in its airline advertising).¹⁰²

The arm's length charge for intercompany services is initially described as the charge that was made or would have been made for the same or similar services in independent transactions between unrelated parties under similar circumstances. Unless the services are "services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services . . . the arm's length charge is deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services."¹⁰³ The taxpayer may, however, establish a more appropriate charge under the general arm's length standard.¹⁰⁴

The regulations contain extensive provisions as to costs and deductions to be taken into account. They also contain this reassuring provision:

Where an arm's length charge for services rendered is determined with reference to costs or deductions, and a member has allocated and apportioned costs or deductions to reflect arm's length charges by employing in a consistent manner a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice, such method will not be disturbed.

Other evenhanded reassurances appear in the cost allocation provisions.¹⁰⁵

Services which are an integral part of the business of either the service provider or the related service recipient must be priced under the general arm's length standard. Services are deemed to be an integral part of the business activities of the service provider if such provider renders services to one or more related parties as one of its principal activities, or if the service provider renders such services to unrelated parties. Except for manufacturing, production, extraction, or construction activity, services are not deemed to be a principal activity of the provider if the cost of rendering the services to related parties is twenty five percent or less of the total costs and deductions of the service provider for the taxable year. If such costs exceed twenty five percent, a facts and circumstances test is applied.

Services are deemed to be an integral part of the business of the related service recipient if the provider is peculiarly capable of providing the services and the services are a principal element in the business of the recipient. Services are also deemed to be an integral part of the

102. *Id.*

103. *Id.* § 1.482-2(b)(3).

104. *Id.*

105. *Id.* § 1.482-2(b)(6).

business of the related service recipient if the total costs and deductions of the provider directly related to providing such related party services are twenty five percent or more of the total costs and deductions of the recipient.¹⁰⁶

Use of Tangible Property. If use of tangible property (real or personal) is transferred by one related party to another, by lease or otherwise, an arm's length rental charge must be paid by the transferee.¹⁰⁷ If, however, the property has been leased by the transferor from an unrelated party and is then subleased, in effect, to the related transferee, the arm's length rental charge may be determined by the taxpayer to be equal to the deductions claimed by the transferor/lessee attributable to the property for the period of use by the related transferee/sub-lessee.¹⁰⁸ The taxpayer may establish a more appropriate rental charge under the general arm's length standard. This "total deductions" safe harbor rule may not be used if either the transferor/lessee, or the transferee/sub-lessee, is regularly engaged in renting property of the same general type to unrelated persons.¹⁰⁹

IV. TRANSFERS OF TANGIBLE PROPERTY—TREASURY REGULATION § 1.482-3

The rules for sales of tangible property between related parties set forth five prescribed methods—the comparable uncontrolled price method, the resale price method, the cost plus method, the comparable profits method, and the profit split method. A sixth category—"unspecified methods"—sets forth the considerations to be employed in departing from the prescribed methods.¹¹⁰ The discussion of each method focuses on comparability and reliability. Each discussion sets forth particular factors requiring possible adjustments for differences between the controlled and uncontrolled transactions being compared. Each also sets forth the same litany as to data and assumptions: "The reliability of the results derived from the [particular method] is affected by the completeness and accuracy of the data used and the reliability of the assumptions made"¹¹¹ Each refers back to the factors described under the best method rule in the General Rules.

Comparable Uncontrolled Price Method. Similarity of products will generally have the greatest effect on comparability in using CUP.

106. *Id.* § 1.482-2(b)(7).

107. *Id.* § 1.482-2(c)(1).

108. *Id.* § 1.482-2(c)(2)(iii)(A).

109. *Id.* § 1.482-2(c)(2)(iii)(B).

110. *Id.* § 1.482-3(a).

111. *Id.* § 1.482-3(b)(2)(iii).

There must also be close similarity in contractual terms and economic conditions; adjustments must be made for differences. If these differences are minor, CUP will be considered to provide the most direct and reliable measure of an arm's length price. If the differences are more than minor, or adjustments for minor differences cannot be achieved, CUP may be used but will be considered less reliable in applying the best method rule. If there are material product differences for which reliable adjustments cannot be made, CUP ordinarily cannot be used.¹¹²

Possible areas of adjustment include product quality; contractual terms (particularly as to warranties, volume, credit, and transportation); market level (wholesale, retail); geographic market; the dates of the transactions compared; intangible property associated with the sale; foreign currency risks; and alternatives "realistically available to the buyer and seller."¹¹³ This latter cryptic reference is not further explained by example or otherwise.

Data from public exchanges or quotation media, such as public crude oil prices, may be used only if the information is "widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales," and adjustments can be made for variations, including differences in risks.¹¹⁴ Such data cannot be used under extraordinary market conditions, as where war breaks out in major oil producing countries.¹¹⁵

Resale Price Method. RPM compares gross profit margins to determine the proper arm's length price. The proper transfer price from the controlled manufacturer to the controlled reseller is the price which will yield the appropriate uncontrolled party gross profit margin to the controlled reseller (expressed as a percentage of sales).

RPM measures the value of functions performed. It is ordinarily used for distributor or dealer cases, such as a controlled U.S. distributor of a foreign manufacturer, or a foreign distributor of a U.S. manufacturer, where the reseller does not add substantial value by physically altering the goods or by using its own intangibles (such as a trademark). Packaging, labelling, or minor assembly is not considered physical alteration for this purpose.¹¹⁶

Gross profit of a reseller represents compensation for resale functions and is a return on the reseller's investment of capital and assumption of risks. Accordingly, comparability depends on the similarity of

112. *Id.* § 1.482-3(b)(2)(ii)(A).

113. *Id.* § 1.482-3(b)(2)(ii)(B).

114. *Id.* § 1.482-3(b)(5)(i).

115. *Id.* § 1.482-3(b)(5)(iii) ex. 1.

116. *Id.* § 1.482-3(c)(1).

functions performed, risks borne, and contractual terms. Comparability is less dependent upon product similarity, unless product differences involve functional differences.

Ordinarily, comparisons should be made to uncontrolled resellers of the same general type of products, such as consumer electronics. Differences in the value of the goods due to a trademark may affect the reliability of the comparison.¹¹⁷ Other differences regarding the controlled and uncontrolled resellers whose gross profit margins are being compared may include the age of their respective plant and equipment, business experience, and management efficiency.¹¹⁸

It is unclear why the plant and equipment of a distributor or dealer has special importance. Furthermore, business experience and management efficiency are exceedingly difficult to assess from available data regarding uncontrolled taxpayers. Accordingly, these latter comparisons may become major areas of controversy.

Adjustments for differences will require consideration of the respective operating expenses of the controlled and uncontrolled parties and risks assumed in order to determine the comparability of the functions performed by them. Particularly relevant factors include: inventory levels, turnover rates, and corresponding risks, including price protection programs provided by the manufacturer; contractual terms (warranties, volume, credit terms, transportation terms); sales, marketing, and advertising programs and services (including promotional programs, rebates, and cooperative advertising); the level of the market (wholesale, retail); and foreign currency risks.¹¹⁹

Accounting consistency is particularly important because differences in inventory or cost accounting practices can materially affect gross profit determinations. The ability to make reliable adjustments for differences, including the classification of discounts, rebates, transportation costs, insurance, and packaging between cost of sales and gross profit, will affect the reliability of the comparison.¹²⁰

Cost Plus Method. This method uses an appropriate uncontrolled gross profit margin (expressed as a percentage of costs) which is added to a controlled manufacturer's costs to yield the proper arm's length transfer price.¹²¹ "The cost plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties."¹²²

117. *Id.* § 1.482-3(c)(3)(ii)(B).

118. *Id.*

119. *Id.* § 1.482-3(c)(3)(ii)(C).

120. *Id.* § 1.482-3(c)(3)(iii)(B).

121. *Id.* § 1.482-3(d)(2).

122. *Id.* § 1.482-3(d)(1).

Here, the manufacturer's gross profit is compensation for performing the production functions, including an operating profit for the investment of capital and for the assumption of risks.¹²³ Accordingly, as in RPM, similarity of functions performed, risks assumed, and contractual terms are most important.

Close physical similarity of products is less important here than under CUP, but substantial differences in product may indicate significant functional differences. Consequently, comparisons should be made with producers of goods in the same product categories.

Differences in product value due to intangibles, such as a trademark, will affect the reliability of the comparison. As in RPM, differences as to age of plant and equipment, business experience, and management efficiency must be considered.¹²⁴

In the case of manufacturers, age of plant and equipment seems far more relevant than in RPM. Again, however, business experience and management efficiency of comparable uncontrolled manufacturers are not easily determinable and will lead to controversies.

Adjustments for differences here also will require consideration of operating expenses to determine comparability of functions performed and risks assumed. Other particularly relevant factors are: complexity of the manufacturing or assembly process; manufacturing, production, and process engineering; procurement, purchasing, and inventory control activities; testing functions, selling, general, and administrative expenses; foreign currency risks; and contractual terms (warranties, volume, credit terms, transportation terms).¹²⁵

Accounting consistency is equally important under RPM because the determination of gross profit must reflect consistency in the allocation of costs between cost of sales and operating expenses.¹²⁶

Unspecified Methods. An unspecified method may be used under the best method rule if it yields a more comparable and reliable indication of an arm's length transfer price than any specified method. The regulations emphasize that use of an unspecified method must reflect that uncontrolled taxpayers will have considered "realistic alternatives." Thus, its use should provide information on prices or profits that the controlled taxpayer could have realized by choosing such an alternative.¹²⁷

An example illustrates these vague provisions. A U.S. producer

123. *Id.* § 1.482-3(d)(3)(ii)(A).

124. *Id.* § 1.482-3(d)(3)(ii)(B).

125. *Id.* § 1.482-3(d)(3)(ii)(C).

126. *Id.* § 1.482-3(d)(3)(iii)(B).

127. *Id.* § 1.482-3(e)(1).

selling to a controlled Canadian distributor receives a bona fide offer from an independent Canadian company to serve as distributor and buy a similar volume of the product at a specified price. If the proposed terms of the independent distributor's offer are sufficiently similar to the proposed terms with the controlled distributor, the independent distributor's proposed price "may provide reliable information indicating that an arm's length consideration . . . will be not less than [that price]."¹²⁸

The regulations, even with this example, provide little useful information about the "realistic alternative" concept. Thus, this concept, which appears repeatedly throughout the regulations, cries out for more explanation.

Coordination With Intangible Property Rules. "[T]he transfer of tangible property with an embedded intangible [is] not . . . considered a transfer of [the] intangible if the controlled purchaser does not acquire any rights to exploit [it] other than rights relating to the resale of the tangible property under normal commercial practices."¹²⁹ This self-evident conclusion seems hardly worth restatement. The embedded intangible must, however, be considered in evaluating comparability of the controlled and uncontrolled transaction. Trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit use of CUP. The effect of embedded intangibles on comparability is to be determined under the intangible property rules.¹³⁰

If the controlled party does acquire the right to exploit the intangible, it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property by applying the intangible property rules.¹³¹

V. TRANSFERS OF INTANGIBLE PROPERTY—TREASURY REGULATION § 1.482-4

These regulations address the far more difficult task of valuing intangible property rights in order to establish an arm's length royalty or lump sum payment upon transfers between controlled parties. They do so in much the same way that transfers of tangible property are tested. The regulations recognize three specified methods: comparable uncontrolled transaction ("CUT"), comparable profits ("CPM"), and profit split, as well as the use of an unspecified method.¹³²

An intangible is defined as an asset with substantial value

128. *Id.* § 1.482-3(e)(2).

129. *Id.* § 1.482-3(f).

130. *Id.*

131. *Id.*

132. *Id.* § 1.482-4(a).

independent of the services of any individual, including: (1) patents, inventions, formulae, know-how, copyrights, artistic compositions, trademarks, brand names, franchises, licenses, and others; (2) methods, programs, surveys, studies, customer lists, technical data, and others. A catch-all category includes other similar items which derive their value not from physical attributes but from their intellectual content or other intangible properties.¹³³

Comparable Uncontrolled Transaction Method ("CUT"). The CUT method depends upon comparability and reliability considerations quite similar to those for transfers of tangible property, such as use of the CUP method. "If an uncontrolled transaction involves a transfer of the same intangible under the same, or substantially the same, circumstances, [the CUT] method will generally be the most direct and reliable measure of the arm's length result"¹³⁴ Allowable differences must be minor ones that have a definite and reasonably ascertainable effect, and for which adjustments can be made.¹³⁵

Differences in contractual terms and economic conditions are particularly relevant.¹³⁶ The intangible transfers being compared must involve intangibles used in connection with similar products or processes within the same general industry or market. They must have similar "profit potential," determined by comparing the net present value of the benefits to be realized, based either on prospective profits to be earned or costs to be saved. The comparison must account for the capital investment and start-up expenses required, risks assumed, and other relevant considerations. Reliability of the comparison will depend on the extent to which the profit attributable to the intangible can be isolated from other factors, such as functions performed and other resources employed.¹³⁷

Also particularly relevant are the nature of the rights granted in the transfer, exclusive or nonexclusive, and restrictions on use and geographical limitations. Other important factors are the stage of development, including any necessary government approvals; the right to receive updates or modifications; the uniqueness of the property and the time it will remain unique; the duration of the license agreement and termination or renegotiation rights; economic and product liability risks assumed by the transferee; the existence of other business relationships between the transferor and transferee; and functions to be performed by

133. *Id.* § 1.482-4(b).

134. *Id.* § 1.482-4(c)(2)(ii).

135. *Id.*

136. *Id.* § 1.482-4(c)(2)(iii)(A).

137. *Id.* § 1.482-4(c)(2)(iii)(B)(1).

the transferor and transferee, including any ancillary or subsidiary services.¹³⁸

One example involves the use of a database of company documents filed with the SEC to identify potentially comparable license agreements between uncontrolled taxpayers. Various management consulting firms have similar files which may be a resource. In the example, the Service first selected fifteen uncontrolled comparables, but because "it is likely that unidentified material differences exist," an "appropriate statistical technique must be used."¹³⁹ The Service employs the interquartile range and determines a royalty rate based on the median of the royalty rates of eleven of the fifteen comparables.¹⁴⁰

Unspecified Methods. Here, as in the case of CUP for tangible property, the regulations require that realistic alternatives of the controlled transferor be considered. Use of an alternative unspecified method "should provide information on the prices or profits."¹⁴¹

As previously discussed, the penalty regulations require, as a condition to avoiding a penalty, that the use of an unspecified method be disclosed in a timely filed return and that the documentation support its use, including the consideration of realistic alternatives.¹⁴²

An example illustrates the realistic alternative requirement. A U.S. parent manufacturer with a proprietary process could supply the European market itself at greater profit than it would otherwise realize under a licensing agreement with a controlled European subsidiary, which manufactures and sells a product in the European market and pays a royalty to the U.S. parent. Presumably, the result is that the Service will increase the royalty to give the U.S. parent the same return it would otherwise realize pursuant to the direct selling alternative.¹⁴³

Periodic Adjustments. These provisions implement the statutory directive in the last sentence of § 482 which was adopted in the Tax Reform Act of 1986: "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."¹⁴⁴ The objective is to insure that the royalty under an agreement extending over a period of years is subject to periodic adjustment by the Service depending on profits actually realized by the transferor, regardless of conditions in prior years. Thus,

138. *Id.* § 1.482-4(c)(2)(iii)(B)(2).

139. *Id.* § 1.482-4(c)(4) ex. 3.

140. *Id.*

141. *Id.* § 1.482-4(d)(1).

142. *Id.* § 1.6662-6T(d)(3)(iii).

143. *Id.* § 1.482-4(d)(2).

144. 26 U.S.C. § 482 (1986).

the regulations state that a determination in an earlier year that the royalty was an arm's length amount does not preclude the Service from making a further adjustment in a later year, regardless of any statutory period for assessment or refund.¹⁴⁵

An exception to this broad rule applies if the same intangible was transferred to an uncontrolled taxpayer under the same circumstances and was used to apply the CUT method in the "first taxable year in which substantial periodic consideration was required to be paid."¹⁴⁶ There can be no IRS adjustment in such a case if the transfer price in that first year was an arm's length amount.¹⁴⁷

A further exception applies if the arm's length result is based on the CUT method by reference to a comparable intangible under comparable circumstances and if:

- (1) the controlled parties executed a written agreement providing for a royalty for each year of the agreement which was an arm's length amount for the first year for which a substantial royalty was to be paid, and the agreement applies to the year in question;
- (2) there exists a written agreement executed under comparable circumstances of the comparable uncontrolled transaction relied upon, and it does not permit renegotiation or termination;
- (3) the controlled agreement limits use of the intangible to a specified field or purpose in a manner consistent with industry practice and any such limitation in the uncontrolled agreement;
- (4) there were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by unforeseeable events; and
- (5) the aggregate profits earned or cost savings realized by the controlled transferee from the intangible for the year in question and all prior years are within the range of eighty percent to one hundred and twenty percent of the prospective profits or cost savings foreseeable when the comparability of the uncontrolled agreement was first established.¹⁴⁸

If a method other than CUT has been used, an exception to the periodic adjustment rule applies under conditions similar to the five listed above, except that there need be no written agreement used as a basis of comparison.¹⁴⁹

Further, if those conditions have been satisfied for each of the first five years in which substantial periodic consideration was required to be paid, no periodic adjustment will thereafter be made by the Service irre-

145. Treas. Reg. § 1.482-4(f)(2)(i) (1994).

146. *Id.* § 1.482-4(f)(2)(ii)(A).

147. *Id.*

148. *Id.* § 1.482-4(f)(2)(ii)(B).

149. *Id.* § 1.482-4(f)(2)(ii)(C).

spective of the eighty percent to one hundred and twenty percent test.¹⁵⁰

These are important and useful exceptions to the periodic adjustment rule, tending to reconcile it with the arm's length principle. Unfortunately, the eighty percent to one hundred and twenty percent range is unduly narrow in light of the other specific conditions for its use.

A further exception to the periodic adjustment rule covers the case where extraordinary and truly unforeseeable events, beyond the control of the taxpayers, have occurred. This exception applies, however, only if the actual aggregate profits or cost savings are *less* than eighty percent, or *more* than one hundred and twenty percent, of the prospective profits or cost savings. Also, the other conditions listed above, if the CUT method has been used, or similar conditions if another method has been used, must have been satisfied.¹⁵¹ Here, the eighty percent/one hundred and twenty percent provisions make reasonable sense; they fairly define the existence of an extraordinary and unforeseeable event.

Developer/Assister Rules. The regulations contain a set of rules to identify the "owner" of the intangible, versus other controlled parties who merely provide assistance in its development. The owner must receive an arm's length consideration, usually in the form of a royalty, upon transfer of its use, whether exclusive or nonexclusive, whether limited by field of use, geographic boundaries, or otherwise. The assisters must receive an arm's length consideration for their contribution to its development, whether in the form of loans, services, or use of tangible property, as provided in the regulations governing those forms of contribution.¹⁵²

Such assistance does not include expenditures of a routine nature that an unrelated party dealing at arm's length would be expected to incur under similar circumstances.¹⁵³ An example illustrates this latter rule as applicable where independent distributors of the same type of product with a foreign manufacturer's brand name incur expenditures to develop the name in the United States.¹⁵⁴

The regulations make it clear that since the right to exploit an intangible can be subdivided in various ways (geographic area, field of use, or otherwise), a single intangible may have multiple owners for purposes of applying these rules.¹⁵⁵

The Service may impute ownership, regardless of the nominal legal

150. *Id.* § 1.482-4(f)(2)(ii)(E).

151. *Id.* § 1.482-4(f)(2)(ii)(D).

152. *Id.* § 1.482-2; *see also supra* notes 89-109.

153. Treas. Reg. § 1.482-4(f)(3)(iii).

154. *Id.* § 1.482-4(f)(3)(iv) ex. 2.

155. *Id.* § 1.482-4(f)(3)(i).

ownership, if the conduct of the parties indicates that in substance another controlled party is the real owner.¹⁵⁶

If the intangible is not legally protected, the developer will be considered the owner. The developer is ordinarily the controlled party that bore the largest share of unreimbursed costs of developing the intangible, including the use, without adequate compensation, of property or services likely to contribute substantially to its development. Other controlled parties will be treated as assisters.¹⁵⁷

Lump Sum Payments. If an intangible is transferred in a controlled transaction for a lump sum, the lump sum must equal an "equivalent royalty amount," determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible, or the period of the controlled agreement, if shorter. The hypothetical royalty stream must take into account the projected sales of the licensee as of the date of transfer. This requires a present value computation using an appropriate discount rate. The equivalent royalty amount then becomes subject to the periodic adjustment rules.¹⁵⁸

VI. COMPARABLE PROFITS METHOD—TREASURY REGULATION § 1.482-5

The initial introduction of the CPM concept in the 1992 proposed regulations resulted in a storm of criticism from the business community and from foreign governments. First designated as the Comparable Profit Interval ("CPI") method, it contemplated use of net profit type data. Comparisons were to be made using "operating profit" from the general class of business activity to be evaluated. Operating profit was defined generally as net profit before tax, excluding extraordinary gains or losses and excluding interest and dividend income.

The data required for the CPM method are readily available from public sources. Conversely, the comparable gross profit data needed to apply the resale price method or the cost plus method, and that necessary to apply the CUT or CUP type methods, are particularly difficult to obtain and generally cannot be obtained from public sources.

The use of such net profit data was not included in the earlier 1968 regulations. Equally important, the prior report of the Committee on Fiscal Affairs of the Organisation for Economic Cooperation and Development (OECD) urged extreme caution in the use of such data because

156. *Id.* § 1.482-4(f)(3)(ii)(A).

157. *Id.* § 1.482-4(f)(3)(ii)(B).

158. *Id.* § 1.482-4(f)(5)(i).

of the danger of insufficient comparability.¹⁵⁹

In the 1992 proposed regulations, the use of CPI was required to confirm the general validity of the use of other methods. The 1993 temporary regulations cut back its role and denied its application if the controlled party being tested had "valuable non-routine intangibles."

The role of CPM under the final § 482 regulations remains important. It has no superior status, and it is not required as a check on the results of other methods, but it may be applied if it satisfies the best method rule.¹⁶⁰

The general concept of CPM is that an arm's length result can, in some circumstances, be determined by "objective measures of profitability," which are named "profit level indicators" ("PLI") in the regulations. PLI are to be obtained from data of uncontrolled taxpayers engaged in "similar" business activities under "similar" circumstances.¹⁶¹ It is evident in the regulations that the standards of required comparability and reliability are far less stringent for CPM than for the transaction-based methods: CUP, RPM, or cost plus for tangible property or CUT for intangibles.

Profit Level Indicators. There are three principal profit level indicators: rate of return on capital, used principally where operating assets are important to producing operating profits, as in manufacturing;¹⁶² the ratio of operating profits to sales, where functional differences, which are generally reflected in such a ratio, are of greater importance, as in distribution businesses; and the ratio of gross profit to operating expenses, the so-called Berry Ratio, also relevant where functional differences are particularly important.¹⁶³ Use of other profit level indicators is possible, but none are identified in the regulations.¹⁶⁴ Generally, the arm's length range will be used to establish comparable operating profit by a single profit level indicator.

The most appropriate PLI is to be applied "to the financial [data for] the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available"¹⁶⁵ "[T]he tested party [should] be the participant in the controlled transaction whose operating profit attributable to controlled transactions can be verified using the most reliable data and requiring the fewest and most

159. See ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 42-43 (1979).

160. Treas. Reg. §§ 1.482-1(c)(1), 1.482-8 ex. 4 and 6 (1994).

161. *Id.* § 1.482-5(a).

162. *Id.* § 1.482-5(b)(4)(i).

163. *Id.* § 1.482-5(b)(4)(ii).

164. *Id.* § 1.482-5(b)(4)(iii).

165. *Id.* § 1.482-5(b)(1).

reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located.”¹⁶⁶ The tested party will usually “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.”¹⁶⁷

The profit level indicator is to be derived from a sufficient number of years of data to reasonably measure the returns of uncontrolled comparables, usually at least the taxable year under review and the preceding two years.¹⁶⁸

Since operating profit represents a return on investment of resources and risks assumed, and since such resources and risks are usually directly related to functions performed, functional comparability of the tested party and the uncontrolled comparable or comparables is particularly important. It is less important, however, than in applying the resale price or cost plus methods because functional differences are generally reflected to a greater degree in operating expenses than in gross profit levels.¹⁶⁹

Similarly, reliability under CPM is not as dependent on product similarity as in other methods. Other factors, less important under CUP, RPM, or cost plus, may be important. These could include varying cost structures (as reflected in the age of a plant and equipment), business experience (start-up versus mature business), or management efficiency (expanding or contracting sales or executive compensation). These latter differences may affect the reliability of the comparison.¹⁷⁰

It is these subjective, hard-to-measure considerations that may create disputes; hard data necessary to evaluate these differences are simply not available.

Adjustments should be made for material differences in both operating assets and operating profits in developing a return on capital employed.¹⁷¹ Material differences in the level of accounts receivable or accounts payable, or both, may require adjustment by an imputed interest charge.¹⁷² Consistency in accounting practices, particularly as to inventories and cost accounting, may impact operating profit and require adjustment.¹⁷³

Allocations between the relevant business activity and other activi-

166. *Id.* § 1.482-5(b)(2)(i).

167. *Id.*

168. *Id.* § 1.482-5(b)(4).

169. *Id.* § 1.482-5(c)(2)(ii).

170. *Id.* § 1.482-5(c)(2)(iii).

171. *Id.* § 1.482-5(c)(2)(iv).

172. *Id.*

173. *Id.* § 1.482-5(c)(3)(ii).

ties may be necessary. If necessary, reasonable allocation formulas may be used.¹⁷⁴ Wherever possible, the comparison should be to the tested party's financial data that are related solely to the controlled transactions.¹⁷⁵

Operating assets include all assets used in the relevant business activity of the tested party. Operating assets do "not include investments in subsidiaries, excess cash, and portfolio investments." Operating assets may be measured by net book value or fair market value, consistently applied from year to year to the comparables, as well as to the tested party.¹⁷⁶

The examples explain how CPM is applied to a controlled distributor by reference to data of uncontrolled distributors in the "same industry segment" performing similar functions and subject to similar risks. The ratio of operating profit to sales is deemed to be the most appropriate PLI. That ratio is found to be "relatively stable where at least three years are included in the average."¹⁷⁷

In one such example, ten controlled wholesalers are selected; their ratios of operating profit to sales range from 1.7% to 10.5%. The available data are not sufficient to conclude that it is likely that all material differences have been identified. Accordingly, an arm's length range is constructed using the interquartile range of results (seventy-five percent probability of a result falling below the upper end and above the lower end). This narrows the range to 3.8% to 6.7%. If the tested party's ratio falls within this range, no adjustment is made. In the case where the tested party's ratio of operating profit to sales falls outside this range, the Service computes the tested party's hypothetical operating profit based on its sales using the operating profit ratios of all ten uncontrolled distributors. The Service then uses the median result to make the adjustment.¹⁷⁸

VII. PROFIT SPLIT METHOD—TREASURY REGULATION § 1.482-6

At the strong urging of high-technology industries, a profit split method has been included in the regulations. It is narrowly drawn and effectively a method of last resort. Nevertheless, this is an important recognition of the reality in everyday practice that uncontrolled parties often set a transfer price by a profit split negotiation. Furthermore, the courts have frequently resorted to a profit split result.

174. *Id.* § 1.482-5(c)(3)(iii).

175. *Id.* §§ 1.482-5(b)(1), 1.482-5(c)(3)(iii).

176. *Id.* § 1.482-5(d)(6).

177. *Id.* § 1.482-5(e) ex. 1.

178. *Id.*

"The combined operating profit or loss [to be split] must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is (sic) available that includes the controlled transactions (relevant business activity)."¹⁷⁹ "The relative value of each controlled [party's] contribution to the success of the relevant business activity must [reflect] the functions performed, risks assumed, and resources employed by each participant"¹⁸⁰ The profit allocated is not necessarily limited to the total operating profit of the relevant business activity; one controlled party may be allocated a larger amount of profit and the other allocated a loss.¹⁸¹ Two methods are prescribed: the comparable profit split and the residual profit split.¹⁸²

Comparable Profit Split. This split is to be based on the relative shares of the combined operating profit of uncontrolled taxpayers with transactions and activities similar to those of the controlled taxpayers.¹⁸³ Comparability considerations are those applicable for the CPM method: functions performed, risks assumed, similarity of cost structures (age of plant and equipment), and possibly business experience and management efficiency. Similarity of the contractual terms under which the controlled parties and the uncontrolled parties have operated is also important. The comparable profit split method cannot be used if the ratio of operating profit to combined operating assets of the uncontrolled parties varies significantly from that of the controlled parties.¹⁸⁴

Residual Profit Split. Under this method, operating income is first allocated to each of the controlled parties to provide a "market return" for "routine contributions" to the relevant business activity.¹⁸⁵ "Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities."¹⁸⁶ Market returns for routine contributions are to be determined from returns of a similar nature to those uncontrolled taxpayers engaged in similar activities.¹⁸⁷

Profit attributable to routine contributions will not include profits attributable to the controlled group's valuable intangibles where similar property is not owned by uncontrolled parties. The unallocated residual profit is accordingly divided among the controlled taxpayers based on

179. *Id.* § 1.482-6(a).

180. *Id.* § 1.482-6(b).

181. *Id.*

182. *Id.* § 1.482-6(c)(1).

183. *Id.* 1.482-6(c)(2)(i).

184. *Id.* § 1.482-6(c)(2)(ii)(B)(1).

185. *Id.* § 1.482-6(c)(3)(i).

186. *Id.* § 1.482-6(c)(3)(i)(A).

187. *Id.*

the relative value of their contributions of nonroutine intangibles. Such relative values may be based on "external benchmarks" (not further defined) that reflect the fair market value of such intangibles. Alternatively, the relative values may be based on the capitalized costs of the intangibles less an appropriate amount of amortization based on the useful life of each such intangible. If such development costs are relatively constant over time, and the useful lives of the intangibles of the controlled parties are approximately the same, actual development expenditures in recent years may be used.¹⁸⁸

The residual profit split is likely to receive more attention from taxpayers because information as to profit splits by uncontrolled parties is difficult to find. The willingness of the Service to accept the relative development costs of key intangibles as the basis for profit split remains to be seen. On the other hand, various forms of the profit split method are being considered in Advance Pricing Agreement ("APA") negotiations, and the Service is expected to provide general information as to the nature of APAs periodically.

VIII. COST SHARING—TREASURY REGULATION § 1.482-7

The final cost sharing regulations were adopted on December 20, 1995.¹⁸⁹ They deal with a "qualified cost sharing arrangement," a kind of joint venture undertaking by two or more members of a controlled group to share in the costs and risks of developing intangible property in return for specified interests in the intangibles developed. The arrangements are based on the proportionate benefits they expect to receive from the joint research activity.¹⁹⁰ Cost sharing agreements were recognized under the 1968 transfer pricing regulations and have a long history of use in some companies and industries.¹⁹¹

Qualified Cost Sharing Arrangement. A Qualified Cost Sharing Arrangement ("QCSA") exists for two or more controlled parties if it provides a method to determine each party's share of intangible development costs based on factors that can reasonably be expected to reflect that party's share of anticipated benefits. It must provide for adjustments for change in economic conditions, differences in the business operations of the parties, and changes in the ongoing development of intangibles under the arrangement.¹⁹²

A written document recording the terms of the QCSA must be exe-

188. *Id.* § 1.482-6(c)(3)(i)(B).

189. Section 482 Cost Sharing Regulations, 60 Fed. Reg. 65,553 (1995).

190. Treas. Reg. § 1.482-7(b) (1996).

191. Section 482 Cost Sharing Regulations, 60 Fed. Reg. 65,553 (1995).

192. Treas. Reg. § 1.482-7(b).

cuted upon its formation and must describe the scope of the research and development to be undertaken. It must spell out each party's interest in the intangibles developed. The terms must include its duration, how it may be modified or terminated, and the consequences upon modification and termination.¹⁹³

"A controlled party may be a participant only if it — [u]ses, or reasonably expects to use covered intangibles in the active conduct of its trade or business"¹⁹⁴ Trade or business activity of another party will suffice if the controlled taxpayer exercises substantial managerial and operational controls over such business.¹⁹⁵ The active business requirement will not be satisfied if a controlled party's principal purpose for participating in the QCSA is to obtain an intangible for transfer or license to another controlled or uncontrolled party.¹⁹⁶

These rules are illustrated by an example where the QCSA nominally includes three controlled parties: U.S. Parent ("USP"), Foreign Sub ("FS"), and the group's research arm ("R&D"). The QCSA is entered into to develop manufacturing intangibles for a new product line. USP and FS are assigned exclusive rights to exploit the intangibles in the United States and Europe respectively, where each presently manufactures and sells existing product lines. R&D, whose activity is solely research for the group, is assigned the exclusive right to exploit the new technology in Asia, where no controlled group member presently operates. R&D expects to assign the Asian rights to an unrelated third party for a royalty. The reasonably anticipated benefits (not taking R&D into account) will be 66-2/3 percent to USP and 33-1/3 percent to FS. The agreement provides that USP and FS will pay for the costs of development activity as follows: USP forty percent, FS twenty percent.¹⁹⁷

Under the new rules, R&D is not treated as a participant but rather as an assister under the developer/assister rules of the intangibles regulation. R&D must receive an arm's length consideration for its services from USP (66-2/3%) and from FS (33-1/3%). Because R&D will not use the research in an active trade or business, the Asian rights held by R&D must be treated as held by USP (66-2/3%) and FS (33-1/3%).¹⁹⁸

Significantly, the collateral tax consequences of a QCSA are specified in the regulations. A QCSA will not be treated as a partnership for federal income tax purposes. Also, a foreign participant will not be clas-

193. *Id.*

194. *Id.* § 1.482-7(c)(1).

195. *Id.* § 1.482-7(c)(2).

196. *Id.* § 1.482-7(c)(1).

197. *Id.* 1.482-7(c)(4)(ii).

198. *Id.*

sified as being engaged in a U.S. trade or business by reason of its participation in a QCSA.¹⁹⁹

The Service may impute the existence of a cost sharing arrangement and apply the rules of the regulations to the parties.²⁰⁰ In such a case, or with respect to any QCSA, adjustments may be made only to the extent necessary to make each party's share of the costs equal to its share of the reasonably anticipated benefits, or to provide for an arm's length consideration for the acquisition of an interest in intangible property by one controlled party from another controlled party.²⁰¹

Costs. A controlled participant's costs of developing intangibles will include all costs incurred in intangible asset development, including costs it incurs under a QCSA and cost sharing payments it makes to other controlled and any uncontrolled participants in a QCSA, except that these amounts must be reduced by cost sharing payments it receives under the QCSA. Depreciation or amortization expense is not included, but the participant's share of any charge for the use of tangible property made available under the QCSA is included. Intangible development costs of a participant must be reduced by consideration effectively received for the use of any intangible property made available by that participant to the QCSA.²⁰²

Anticipated Benefits. The determination of the anticipated benefits to each participant is the key factor in the application of the QCSA provisions; it determines the cost shares of the participants. Anticipated benefits include additional income or cost savings, or both, to be derived from activities under a QCSA.²⁰³ Anticipated benefits of an uncontrolled participant are not included in determining each controlled participant's share of anticipated benefits.²⁰⁴ The reasonably anticipated benefits of each controlled participant must be determined on a consistent basis. The basis that provided the most reliable estimate for a particular year will ordinarily provide the most reliable estimate in subsequent years, absent material changes in the factors affecting reliability.²⁰⁵

Possible bases for measuring anticipated benefits include units to be used, produced, or sold in the business activities of each controlled participant in which the covered intangibles are to be exploited. This basis will be reliable to the extent each controlled participant is expected

199. *Id.* § 1.482-7(a)(1).

200. *Id.* § 1.482-7(a)(1).

201. *Id.* § 1.482-7(a)(2).

202. *Id.* § 1.482-7(d)(1).

203. *Id.* § 1.482-7(b)(2).

204. *Id.* § 1.482-7(f)(3)(i).

205. *Id.* § 1.482-7(f)(3)(ii).

to have a similar increase in net profit (or decrease in net loss) attributable to the covered intangibles per unit of the items used, produced, or sold. This determination generally assumes that substantially uniform items are involved under similar economic conditions.²⁰⁶

Sales may be used if each controlled participant is expected to experience a similar effect on net profit or loss per dollar of sales attributable to the covered intangibles. This will most likely occur if the costs of exploiting such intangibles are not substantial relative to revenues generated, or if the principal effect of using the intangibles is to increase revenues without substantially affecting costs. However, each controlled participant must be operating at the same level of the market (manufacturing, wholesaling, retailing, etc.).²⁰⁷

Operating profit will be a more reliable measure if such profit is largely attributable to the use of covered intangibles, or if the share of profits attributable to such intangibles is expected to be similar for each controlled participant. This is likely to be true if the covered intangibles will be an integral part of the activity that generates the profit and the activity could not be carried on, or would generate little profit, without such intangibles.²⁰⁸

An example illustrates the use of operating profit to establish relative anticipated benefits from QCSA research involving a proprietary drug. The U.S. parent is likely to realize much higher profits per unit because drug prices are not controlled in the U.S. but are regulated in many European countries in which the U.S. parent's foreign subsidiary would sell the drug.²⁰⁹

The estimate of anticipated benefits should take into account the estimated time period from inception of the research until the potential benefits will be received by the participants. It also should reflect a projection of the benefits to be received in each year the intangible is likely to produce such benefits. If there is expected to be a significant variance in the timing of receipt of benefits by the controlled participants, it may be necessary to compare the estimated present value of those estimated future benefits.²¹⁰

A significant divergence (more than twenty percent) between projected benefit shares and actual benefit shares will allow the Service to make adjustments on the basis of the actual benefits. For this purpose, all non-U.S. persons who are participants will be treated as a single con-

206. *Id.* § 1.482-7(f)(3)(iii)(A).

207. *Id.* § 1.482-7(f)(3)(iii)(B).

208. *Id.* § 1.482-7(f)(3)(iii)(C).

209. *Id.* § 1.482-7(f)(3)(iii)(E) ex. 4.

210. *Id.* § 1.482-7(f)(3)(iv)(A).

trolled participant.²¹¹

The Service will not make such an adjustment, however, if the divergence is due to an extraordinary event beyond the control of the participants that could not reasonably have been anticipated at the time the costs were shared.²¹²

The Service may make an adjustment in any event if the parties did not use the most reliable method for measuring anticipated benefits.²¹³ Also, the Service will make an adjustment because of an unreliable adjustment even as to foreign controlled participants, if necessary to prevent a substantial reduction in U.S. tax, as where the effect is to decrease Subpart F income of a U.S. parent.²¹⁴

The twenty percent leeway factor for differences between estimated future benefits and actual benefits is exemplified in the regulations. U.S. Parent ("USP") and Foreign Subsidiary ("FS") project a division of total future benefits of sixty/forty. They actually realize a fifty/fifty split. Although USP's actual benefits are within twenty percent of the projection, FS's share is not. In these circumstances, the Service may conclude that the projections were not reliable and may use actual shares to reallocate the sharing of the QCSA research costs.²¹⁵

Buy-In Payments. A controlled participant that makes its own intangible property available to a QCSA (the contributor) is treated as having transferred interests in such property to the other controlled participants, who must make arm's length buy-in payments to the contributor controlled participant. Similarly, any change in a controlled participant's interest in QCSA intangibles, whether by entry of a new participant or transfers of interests among existing participants, is such a transfer, requiring an arm's length buy-in payment by the controlled participants whose interests are increased in order to equal those whose interests are decreased.²¹⁶

This may require a complex determination involving offsets. The buy-in payment from each controlled participant must be the arm's length charge for use of the intangible, determined under §§ 1.482-1 and 1.482-4 of the § 482 regulations, multiplied by the payor controlled party's share of anticipated benefits. Offset against this will be any payments owed to such payor controlled party from other controlled participants.²¹⁷

211. *Id.* § 1.482-7(f)(3)(iv)(B).

212. *Id.*

213. *Id.*

214. *Id.* §§ 1.482-7(f)(3)(iv)(C).

215. *Id.* § 1.482-7(f)(3)(iv)(D) ex. 7.

216. *Id.* § 1.482-7(g)(1).

217. *Id.* § 1.482-7(g)(2).

This determination is illustrated by an example where four controlled participants each contribute intangibles for use under their QCSA.²¹⁸ The relative cost shares, based on anticipated future benefits, and the arm's length charges due each participant for the intangibles contributed by that party, are as follows:

Participants	Arm's Length Charge	
	Cost Shares (%)	Due Such Participant
A	40	\$80X
B	15	40X
C	25	30X
D	<u>20</u>	30X
	100	

The final adjustments among them are as follows (all in X dollars):

	A	B	C	D
Payments	(40)	(21)	(37.5)	(30)
Receipts	<u>48</u>	<u>34</u>	<u>(22.5)</u>	<u>24</u>
	8	13	(15)	(6)

To illustrate, *A* is obligated to pay *B*, *C*, and *D* its share of the arm's length charge due each of them. Thus, *A* must pay *B* 40% of a total of 100X (40X + 30X + 30X), or \$40X. *A* is entitled to receive *B*, *C*, and *D*'s shares of the arm's length charge due to *A* (60% of \$80X = \$48X). *A*'s net settlement amount is a receipt of \$8X. The overall net result is that *A* and *B* are treated as receiving \$8X and \$13X respectively pro rata out of payments by *C* and *D* of \$15X and \$6X respectively.²¹⁹

The net payments due may be in the form of a lump sum payment, an installment payment spread over the period of use of the intangible, with interest as provided in Treas. Reg. § 1.482-2(a), or royalties or other payments contingent on the use of the intangible by the transferee.²²⁰

Character of Payments Made Pursuant To A QCSA. Payments made by a QCSA participant, other than buy-in payments, are considered costs of developing intangibles of the payor. Thus, if they otherwise qualify, they are research and experimental costs deductible under I.R.C. § 174 and intra-group transactions for purposes of the research credit as provided in Treasury Regulation § 1.41-8(e). A controlled par-

218. *Id.* § 1.482-7(g)(8) ex. 4.

219. *Id.*

220. *Id.* § 1.482-7(g)(7).

ticipant's payment is deemed to be reduced by payments owed to it under the QCSA from other controlled or uncontrolled participants. Payments received in excess of deductions otherwise allowable are treated as consideration for the use of tangible property made available to the QCSA by the payee.²²¹

Accordingly, if a United States parent ("USP") and a foreign subsidiary ("FS") in Country Z execute a QCSA, agreeing to share the total costs forty/sixty, respectively, and each party incurs operating expenses of \$100X, FS must pay USP \$20X each year. USP is treated as having incurred \$80X of such costs each year for purposes of allocation and apportionment of deductions to the U.S. source. FS will be treated on its Form 5471 as having a \$100X deduction for activities in Country Z and a \$20X deduction for activities in the United States.²²²

Documentation and Reporting Requirements. A controlled participant must maintain documentation as previously described²²³ which establishes the following:

- (1) The total costs incurred pursuant to the arrangement;
- (2) The costs borne by each controlled participant;
- (3) A description of the method actually used to determine each controlled participant's share of the intangible development costs, including the projections used to estimate benefits, and an explanation why that method was selected;
- (4) The accounting method used to determine the costs and benefits of the intangible development (including foreign currency translation) and an explanation of any material differences from generally-accepted accounting principles; and
- (5) Prior research, if any, undertaken in the intangible development area, and tangible or intangible property made available for use in the arrangement by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles.²²⁴

Each controlled participant must attach a statement to its U.S. income tax return that it is a participant in a QCSA and list the other controlled participants.²²⁵

Effective Date. The cost sharing regulation is effective January 1, 1996.²²⁶ A cost sharing arrangement will be a QCSA under this regulation if it qualified under Treasury Regulation § 1.482-7T, adopted April

221. *Id.* § 1.482-7(h)(1).

222. *Id.* § 1.482-7(h)(2) ex. 1.

223. *See id.* § 1.482-7(b)(4).

224. *Id.* § 1.482-7(j)(2).

225. *Id.* § 1.482-7(j)(3).

226. *Id.* § 1.482-7(k).

1, 1995, but only if it is amended, if necessary, to conform to the new provisions by December 31, 1996.²²⁷

IX. CONCLUSION

The § 482 regulations are an extraordinary application of microeconomic concepts in exquisite detail that implement the statutory requirement for arm's length consideration upon transfers of property or services between related parties. In general, they will achieve reasonable results if the Service, while applying them, remains cognizant of the difficulty in obtaining comparative data.

The penalty regulations are another matter. If rigorously applied, they demand a level of recordkeeping, sophistication, and documentation that only the largest corporations can fully satisfy. As stated earlier, the Service is most likely to achieve the White Paper objectives, which require taxpayers to develop and document their transfer pricing methodology in advance of filing their returns, through a reasonable application of these provisions. If the Service does not, the courts will fashion results to achieve reasonable treatment.

227. *Id.* § 1.482-7(1).