Chapter 13
United States

Mark Madrian, Jill Weise, Allison Kroll & Jeffery Cozzo

1. REGULATORY FRAMEWORK

1.1. Overview and Legal Authority of Sections 482 and 6662

The United States tax law governing transfer pricing is covered under Internal Revenue Code section 482 and its associated regulations. While the code section itself is a single paragraph long, the supporting regulations are several hundred pages in length and comprise economic theory, methods of analysis, and a series of examples designed to assist the taxpayer in understanding how the regulations should be applied to determine arm's-length prices.

Since 1917, the US Congress has empowered the Internal Revenue Service (IRS) to take actions to more accurately reflect US income through various statutory mechanisms. The arm's-length standard was first introduced in the Revenue Act of 1934 to prevent taxpayers from shifting domestically generated income overseas. The United States first formally incorporated the arm's-length concept in its section 482 regulations in 1968, and were substantially revised in 1994. From 1934 through today, the arm's-length standard has served as the guiding framework for transfer pricing regulation in the United States. Following the United States' lead, many other industrialized countries have adopted the concept of arm's-length pricing and have developed detailed rules.

Income tax regulations associated with the pricing of intercompany transfers of tangible goods and intangible goods and with the determination of interest for intercompany loans have remained relatively consistent since issuance of the revised regulations in 1994. More recently, the US Treasury Department released updated regulatory guidance related to the provision of intercompany services in 2006 (finalized in 2009) and to cost sharing

arrangements in 2009 (which are, as of the date of this publication, in temporary form). This increased regulatory activity generally reflects the government view that in many instances transfer pricing has and is being used by many multinational companies to arbitrarily shift income overseas to jurisdictions that enjoy lower corporate tax rates.

The US transfer pricing tax law also includes section 6662 of the Internal Revenue Code, which dictates the circumstances under which penalties for non-compliance with section 482 will apply and the magnitude of those penalties under different scenarios. In addition to introducing a penalty regime, section 6662 offers taxpayers protection against the imposition of such penalties, provided that the taxpayer satisfies certain documentation requirements.

Specifically, section 6662 defines ten principal documents that a taxpayer is required to prepare prior to the timely filing of the taxpayer's US return each year. Compliance with this contemporaneous documentation requirement generally allows the taxpayer to avoid penalties imposed by the IRS as long as the analysis and supporting documentation is reasonable and done in good faith. The specific documents required can be found in Treasury Regulation section 1.6662-6(d)(2)(iii)(B). These Documents are discussed in more detail in section 3.1 below.

1.2. Relationship between Section 482 and the OECD Guidelines

Generally, section 482 and the OECD Guidelines follow consistent concepts and articulate similar methods of analysis for different types of transactions. However, given that the US rules are regulations rather than general guidance, they tend to be more detailed and authoritative in nature. The OECD has released many of its updated reports in response to changing regulations in the United States.

In addition to differences in the level of detail offered in each framework, there are subtle and not so subtle differences between the two sets of guidance. These differences are often at the heart of transfer pricing controversies, both at the financial reporting level and in tax compliance disputes. Certain key differences between the 482 regulations and the OECD Guidelines are discussed below.

1.2.1. Choice of Method

Section 482 utilizes the concept of 'best method'. According to the 482 regulations, the best method is one 'that, under the facts and circumstances,

provides the most reliable measure of an arm's-length result'.[1] With this concept, no method is considered more reliable than others a priori.

Contrary to this view, the current OECD Guidelines, released in final form in 1995, have a strict preference for transactional methods over profit-based methods.[2] Specifically, the OECD Guidelines state that '[t]raditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, traditional transaction methods are preferable to other methods.'[3] Traditional transaction methods within the OECD framework include:

- the comparable uncontrolled price (CUP) method;
- the resale price method (RPM); and
- the cost plus method.

The fact that the US Best Method Rule is inconsistent with the strict preferences under the OECD framework often leads to inconsistent results when testing the arm's-length nature of a transaction. Typical examples of this inherent conflict are cases where transactional methods are dismissed as best methods under the 482 regulations because they do not meet certain comparability criteria, whereas under the OECD Guidelines, a transactional method would still be preferred, even if certain differences could not be corrected.

1.2.2. The Use of Safe Harbours

In a few instances, the US rules have allowed for the use of safe harbours. Generally, safe harbours in a transfer pricing context provide that the taxpayer need not demonstrate that the pricing of certain transactions meets the arm's-length standard. Specifically, the 482 regulations, under proper circumstances, provide safe harbours for the pricing of intercompany debt, as well as for the pricing of certain low value-added intercompany services.

The OECD Guidelines discuss the benefits and concerns that are associated with its members providing country-specific safe harbours.

1. Treasury Regulation §1.482-1(c)(1).
2. However, the OECD guidelines released in 1995 acknowledge that transfer pricing is not always a precise science and may entail instances when '. . . the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable'. OECD Guidelines Chapter 1. It should be noted that this strict preference is largely relaxed in the OECD guidelines discussion draft issued late 2009. Discussion papers released to date make reference to the adaptation of a 'most appropriate method' concept, one that is not unlike the "best-method rule" under the 482 regulations'.
3. OECD Guidelines Ch. 2.49.

The clearest benefit to taxpayers is that a safe harbour, when utilized, may dramatically decrease the compliance and examination burdens. The clearest detriment is that a country-specific safe harbour may not be recognized as producing an arm's-length result by other taxing authorities, and using a safe harbour to meet the transfer pricing requirements for one country may expose the taxpayer to otherwise avoidable controversy and potential double taxation.

1.2.3. Profit-Based Methods: CPM versus TNMM

Generally, there are two profits-based methods described under 482, and two methods described in the OECD Guidelines. One method, the profit split method, is consistent both conceptually and practically in use and application in both frameworks.

However, the comparable profits method (CPM) under the 482 regulations and the transactional net margin method (TNMM) under the OECD Guidelines, although similar in concept, are not quite the same method of analysis. The subtle differences in the methods are often overlooked by taxpayers and practitioners, which has led in many instances to controversy in financial reporting and in tax.

The CPM is discussed in some detail below in section 2.2.2, but as a general concept, this method tests the arm's-length nature of a transaction or a group of transactions by testing a controlled entity's profitability against the profits earned by comparable unrelated companies. If an entity's profits are consistent with companies performing similar functions and bearing similar risks, then the prices charged or paid to related parties must be arm's length.

Similarly, the TNMM looks to benchmark a related entity's profitability against the profits earned by comparable companies. The critical difference in the methods centres on whether different types of transactions can be bundled together for the purposes of testing. Typically, applications of the CPM may incorporate broader definitions of product or functional similarity, both as it applies to defining taxpayer segments to test and as it applies to the selection of appropriate comparables.

1.2.4. Cost Sharing Agreements/Cost Contribution Agreements

One of most obvious and often talked about differences between the 482 regulations and the OECD Guidelines is related to the topic of cost sharing. Cost sharing has been a major focus of the US Treasury and the IRS for several years, and it is discussed in great detail in section 2.5 below. In December 2008, the US Treasury released voluminous new, temporary regulations

regarding cost sharing. These regulations require a very strict adherence to form as well as substance, and they introduce a specific vernacular that is unique to this section of the regulations. A taxpayer's ability to operate within the cost sharing framework is viewed more as a privilege than a right. The regulations require the taxpayer to structure its cost sharing agreement in specific ways and to provide detailed documentation unique to this type of structure.

In contrast, the OECD Guidelines' discussion of 'cost contribution arrangements' (CCA) is less than twenty pages long, and it focuses on the need for any cost contribution arrangement to be consistent with the arm's-length standard. In many instances, CCA may meet the general standards set out in the OECD Guidelines but may not meet the more stringent requirements under section 482.

1.3. Summary of Transfer Pricing Regulatory Framework

The US transfer pricing laws and regulations provide rules for determining the accurate taxable income of controlled taxpayers in specific situations.[4] The rules apply to intercompany transfers between related parties of tangible property, intangible property, and services across international borders, as well as to controlled financial transactions. The specifics of sections 482 and 6662 are discussed in this chapter.

1.3.1. Intercompany Transactions: Identification and Characterization

Generally, to avoid transfer pricing related penalties under the US transfer pricing regulations, all intercompany transactions must be identified, evaluated under the 482 regulations and documented as occurring at arm's length.

Intercompany transactions include the sale, assignment, lease, license, loan, advance, contribution, or any other transfer of interest in or a right to use any property or money between two or more taxpayers under common control. Identification of intercompany transactions often proves a difficult task, especially in instances where the taxpayer's multinational businesses are highly integrated.

The identification of intercompany transactions is typically best done by performing a detailed analysis of the taxpayer's contribution to the overall supply chain and value chain on a legal entity by legal entity basis. This is

4. In this context, accurate taxable income means the income a controlled taxpayer would have earned if dealing at arm's length with related parties.

called a 'functional analysis'. Generally speaking, a functional analysis should include developing a detailed understanding of each legal entity's functions performed, risks borne and assets utilized. Understanding each entity's role and contributions relative to the others' allows the taxpayer to better understand how the legal entities interact with one another, and therefore identify the intercompany transactions that occur between them. In addition, this detailed factual understanding gives the taxpayer insight into the proper characterization of each identified transaction.

The rules under Treasury Regulation §1.482 on how to evaluate the arm's-length nature of an intercompany transaction are segmented by transaction type, or characterization. In turn, specific sections of the transfer pricing framework address the evaluation of tangible, intangible, and service transactions. Therefore, properly characterizing a transaction is critical to appropriately evaluating its arm's-length nature. For instance, certain transactions that appear to be services may in fact give rise to the creation of intangibles, such as the provision of research and development services by one related party to another. Similarly, certain intercompany sales of tangible property may reflect a service transaction, such as the provision of contract manufacturing services to a related party.

Given the complexity of most multinational taxpayers, due care should be given to performing a detailed functional analysis. The failure to properly identify intercompany transactions may lead to their inadvertent omission or mischaracterization. Such mistakes, may, under certain facts and circumstances, subject a taxpayer to transfer pricing related penalties.

1.3.2. Functional Analysis

Per the regulations, a functional analysis identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. It should also include consideration of the resources that are employed, or will be employed, in conjunction with the activities undertaken, including consideration of the types of assets used, such as plant and equipment, or the use of valuable intangibles. In practice, performing a functional analysis allows the taxpayer to identify and characterize its controlled transactions, and it is generally performed by developing a detailed understanding of a multinational company's supply and value chains.

Once completed, the functional analysis should be documented as part of a taxpayer's required documentation under section 6662. Examples of functions typically covered by a functional analysis are presented in Table 13.1 below.

Table 13.1. Functional Areas of Review

Functions[5]
Research and development
Product design and engineering
Manufacturing, production and process engineering
Product fabrication, extraction, and assembly
Purchasing and materials management
Marketing and distribution functions, including inventory management, warranty administration, and advertising activities
Transportation and warehousing
Managerial, legal, accounting and finance, credit and collection, training, and personnel management services

In addition to understanding the functions being performed by each relevant related party, the taxpayer must also determine the relative risks born by each party. Examples of risks typically covered by a functional analysis are presented in Table 13.2 below.

Table 13.2. Risk Areas of Review

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

1.4. Arm's-Length Standard

United States transfer pricing regulations and requirements are guided by the arm's-length standard, which is used to measure the accurate taxable income

5. Treasury Regulation §1.482-1(d)(3)(i).
6. Treasury Regulation §1.482-1(d)(3)(iii)(A).

of a taxpayer engaged in a controlled transaction.[7] To meet the arm's-length standard, a taxpayer's controlled transaction must be priced consistently with the price that would occur if the parties in question were unrelated. This means that the taxpayer's controlled intercompany price must be the same as the price at which two unrelated parties would conduct an identical transaction. Fundamentally, the objective of the regulations is to put a taxpayer with related party transactions on tax parity with a taxpayer with no related party transactions.[8]

Clearly, an identical third party transaction is the most reliable benchmark for which to assess the arm's-length nature of a controlled transaction. Unfortunately, the likelihood of finding such an identical transaction is exceedingly rare given that for a transaction to be identical to another, it must, at a minimum, occur between unrelated parties that are identical to the related parties in question, occur at the same time and at the same volume, and occur under the same contractual terms. In fact, given the complexity of the market and its participants, such identical uncontrolled transactions typically do not exist. The difficulty of finding an identical transaction is recognized in Treasury Regulation §1.482-1(b)(1), which states 'because identical transactions can rarely be located, whether a transaction produces an arm's-length result generally will be determined by reference to results of comparable transactions under comparable circumstances'. Thus, the arm's-length standard is usually determined by referencing comparable, but not identical, transactions that are independent or uncontrolled, and take place under comparable circumstances.

A transaction is considered comparable as long as it is sufficiently similar to the controlled transaction, and is able to provide a reliable measure of an arm's-length result. The required level of comparability varies by the type of method used to evaluate the arm's-length nature of a controlled transaction. The comparability requirements for each method of analysis are discussed in section 2.

1.4.1. Available Methods and the Best-Method Rule

Under Treasury Regulation §1.482, there are specific methods used to evaluate the arm's-length nature of each type of transaction. The regulations also contain a best-method rule, which is used to establish which method should be selected to evaluate the arm's-length nature of a controlled transaction.

7. A controlled transaction is a transaction that takes place between two or more related parties. This may also be referred to as an 'intercompany transaction'.
8. Treasury Regulation §1.482-1(a)(1).

The best-method rule states, 'The arm's-length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's-length result.'[9] To determine whether or a not a method is considered 'best', the taxpayer must take into account '. . . the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis'.[10] An unspecified method may also be selected as the best method, provided the taxpayer demonstrate why the specified methods under 482 could not be applied or would not produce an arm's-length result.

Table 13.3 below lists the available methods, by transaction type. Each of these methods is further discussed in section 2 below.

Table 13.3. Methods Used to Establish the Arm's-Length Standard

Tangible Methods	*Intangible Methods*	*Services Methods*
N/A	N/A	Services Cost Method (SCM)
Comparable Uncontrolled Price (CUP) Method	Comparable Uncontrolled Transaction (CUT) Method	Comparable Uncontrolled Services Price (CUSP)
Resale Price Method (RPM)	N/A	Gross Services Margin Method (GSMM)
Cost Plus Method	N/A	Cost of Services Plus Method
profit split Method	profit split Method	profit split Method
Comparable Profits (CPM) Method	Comparable Profits (CPM) Method	Comparable Profits (CPM) Method
Unspecified Methods	Unspecified Methods	Unspecified Methods

There is no strict hierarchy of methods under the US transfer pricing framework, and no single method is considered better than another *ex ante*. However, the taxpayer must choose a method that provides the most reliable result, considering the facts and circumstances of the controlled intercompany transaction under review. This determination is made by reviewing the data and comparability requirements of each method as outlined in the regulations, and assessing the availability of data related to the transaction under review. Additionally, where possible, the taxpayer is encouraged to support the

9. Treasury Regulation §1.482-1(c)(1).
10. Treasury Regulation §1.482-1(c)(2).

conclusions reached under the best method with the results reached under another, supporting method.[11]

The available methods of analysis under the regulations can be considered either transactional or profit-based.[12] Transactional methods evaluate the arm's-length nature of a controlled transaction by comparing the terms of (or results realized under) that transaction to the terms of (or results realized under) sufficiently similar transactions that occur between unrelated parties. This is either done directly, by comparing prices to prices, or indirectly, by comparing the gross margins or gross profit markups earned. Profit-based methods examine the profits that are earned from a particular set of controlled transactions, and determine whether or not the actual allocation of profits that resulted from the company's transfer prices was consistent with those that would have been realized at arm's length, either through a comparison of those profits against the profits earned by comparable companies (under CPM) or through a comparison of the profit allocation across participants to what would have been expected given the functions and risks of the parties involved (under the profit split method).[13]

Under the 482 regulations, transactional methods include the CUP, CUT, CUSP, the RPM, GSMM, the cost plus method and the cost of services plus method. Profit-based methods include the CPM and the profit split method.[14]

To determine which method provides the 'best' or most reliable measure of an arm's-length result, the taxpayer must take into account the degree of comparability between the controlled transaction and any uncontrolled transactions, and the quality of the data and assumptions used in the analysis. The concept of comparability is addressed in Treasury Regulation §1.482-1(c)(2)(i). Practically speaking, comparability requirements tend to be harder to meet when applying transactional methods than when applying profit-based methods. When determining comparability between a controlled transaction and uncontrolled transaction, or between a tested-party and a potentially comparable company, the taxpayer should analyse the various factors that may affect prices or profits as well as the 'completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions'.[15] Certain

11. Treasury Regulation §1.482-1(c)(2).
12. These terms are not explicitly used in the regulations, but are commonly used among transfer pricing practitioners. Introducing these terms in the 482 context is also useful for the later discussion regarding the comparison of 482 to the OECD guidelines.
13. Exceptions to this typically occur in whole or in part when applying the profit split method and will be discussed later in this chapter.
14. The SCM is not listed here as it is an elective method that, if applied, avoids the need to perform a best method analysis.
15. Treasury Regulations §1.482-1(c)(2)(ii).

factors may be of particular importance, depending on the method being considered. Comparability factors include but are not limited to:

- functions;
- contractual terms;
- risks;
- economic conditions; and
- property or services.[16]

Data-quality considerations include, but are not limited to:

- completeness and accuracy of data;[17]
- reliability of assumptions that are made (i.e., interest rates used in adjustments or expenses that reflect intangible value); and
- sensitivity of results to deficiencies in the data and assumptions.[18]

After reviewing the comparability factors and analysing the data and assumptions, the taxpayer can determine whether an uncontrolled transaction or company may be used to establish an arm's-length result under a particular method. If the taxpayer is aware of material differences between the controlled transaction and the uncontrolled transaction (or the tested party and a comparable company), and if these material differences will affect the arm's-length result, the regulations state that either adjustments must be made to the uncontrolled transactions to improve their relative comparability to the transaction under review, or a different method must be utilized that has different comparability requirements.

Adjustments must be made if they improve the reliability of the arm's-length result. Specifically, as noted in Treasury Regulation §1.482-1(d)(2), 'adjustments must be made to the results of the uncontrolled comparable and must be based on commercial practices, economic principles, or statistical analyses. The extent and reliability of any adjustments will affect the relative reliability of the analysis'.

If a profit-based method is employed, the taxpayer may need to adjust comparable company data to improve comparability. Common adjustments made to comparable company financial data may include, but are not limited to:

- last in, First Out (LIFO) to First In, First Out (FIFO) inventory valuation adjustments;
- working capital adjustments (e.g., accounts receivable, accounts payable, and inventory);

16. Treasury Regulation §1.482-1(d)(1).
17. The more complete and accurate the comparable data, the more reliable the arm's-length analysis will be. If data is not accurate, it may be difficult to determine if the comparable data will provide a reliable arm's-length result.
18. Treasury Regulation §1.482-1(c)(2)(ii).

– net Property, Plant and Equipment (PP&E) adjustments; and
– operating expense adjustments.

Performing appropriate adjustments on comparable company data should serve to minimize differences between the tested party and the comparable, thus improving the reliability of the results. However, adjustments that lead to significant differences in the operating results of the comparable companies should be reviewed critically because such large changes may signify an inappropriate adjustment or that the comparable company may not meet the comparability criteria required in applying the method in question.

1.4.2. Arm's-length Range

In some instances the application of the best method may produce a single result, and in other instances the method may produce a number of results. Typically, more than one result is produced because a third party transaction or independent company may be comparable to a controlled transaction or tested party, but it is not identical. Therefore, a sample of results is desirable so that a range of arm's-length benchmarks can be derived.

Once the set of comparable prices or profits has been established, a statistical method is applied to the results, such that 'there is a 75% probability of a result falling above the lower end of the range and a 75% probability of a result falling below the upper end of the range'.[19] This is known as the 'interquartile range'.

The interquartile range represents an arm's-length range for which the controlled transactions can be evaluated. If a taxpayer's result falls within the arm's-length range, no adjustments are necessary. If the taxpayer's result falls outside of the arm's-length range than an adjustment is warranted. The adjustment is typically made to the median of the range, rather than to the nearest quartile.

2. DETERMINING THE ARM'S-LENGTH PRICING FROM A US PERSPECTIVE

The final US regulations recognize that 'the application of a method may produce a number of results from which a range of reliable results may be derived'.[20] To avoid income adjustments, the results of the controlled party should fall within this 'arm's-length range'. Such a range is ordinarily determined by 'applying a single pricing method selected under the best-method rule to two or more uncontrolled transactions of similar comparability and

19. Treasury Regulation §1.482-1(e)(2)(iii)(B).
20. Treasury Regulation §1.482-1(e)(1).

reliability'.[21] The following subsections analyse each pricing method prescribed under the US Regulations.

2.1. Tangible Property Transactions

As mentioned previously, the final US regulations define six methods for testing the arm's-length nature of intercompany transfers of tangible property. These are:

- the comparable uncontrolled price (CUP) method;
- the resale-price method;
- the cost-plus method;
- the comparable profits method (CPM);
- the profit split method; and
- any other reasonable sixth method (known as an 'unspecified method').

Because the CPM, the profit split method, and unspecified methods are also accepted methods for intangible property transactions, they are discussed in section 2.2. The methods unique to the transfer of tangible property and their applications are discussed below.

2.1.1. Comparable Uncontrolled Price Method

2.1.1.1. Description

The CUP method 'evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a CUT'.[22] When assessing the factors affecting the degree of comparability between controlled and uncontrolled transactions, similarity of products generally will have the greatest relevance. Where there are material product differences for which adjustments cannot be made, this method ordinarily will not qualify as the best method. The close similarity of contractual terms and economic conditions is also highly important for establishing comparability. Additional factors to consider include level of the market, geographic market, date of transaction, intangible property, foreign currency risk, and realistically available alternatives.

Although the Regulations do not give explicit priority to any single method, they do state that under certain circumstances the results derived from applying the CUP method will generally provide the most reliable measure of an

21. Treasury Regulation §1.482-1(e)(2)(i).
22. Treasury Regulation §1.482-3(b)(1).

arm's-length price.[23] That is, the uncontrolled transaction should not differ from the controlled transaction in any way that might affect price, or these differences should be minor and should have a definite and reasonably ascertainable effect on price for which adjustments can be made. Differences that are more than minor or the inability to make adjustments will reduce the reliability of the CUP method.

2.1.1.2. Application Example[24]

Company A, a US manufacturer, sells auto parts to a related Canadian entity for resale to unrelated Canadian OEMs (the controlled transaction). Company A manufactures and sells similar auto parts to original equipment manufacturers (OEMs) in the United States (the uncontrolled transaction). The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. (freight on board) to Company A's factory. The two transactions have differences in the geography and contractual terms of transportation and insurance, but these generally have a definite and reasonably ascertainable effect on price such that adjustments can typically be made.

No other material differences have been identified between the controlled and uncontrolled transactions, and since Company A sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. Therefore, the CUP method can be applied. Because the CUP here is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences which can be adjusted for, the results of this application will provide the most direct and reliable measure of an arm's-length result.

2.1.2. Resale Price Method

2.1.2.1. Description

The RPM relies upon an analysis of the gross profit margins earned in CUTs to test the arm's-length nature of charges in a controlled transaction. It measures the value of functions performed, and is frequently employed where tangible property has been purchased and resold without substantial value having been added to the product by the reseller. The practical use of this method entails setting the controlled price such that the tested party reseller earns a gross

23. Treasury Regulations §1.482-1(c)(2)(i).
24. This section is based on the example(s) provided in Treasury Regulation §1.482-3(b)(4), though some facts may have been altered for clarity of the example.

margin that is within the arm's-length range of gross margins earned by similarly situated resellers in uncontrolled transactions.

Comparability under the RPM 'is particularly dependent upon similarities in functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences'.[25] It is less dependent upon close physical similarity of property, although substantial variations in property may indicate significant functional differences. Other factors affecting comparability include inventory levels and turnover rates, sales, marketing, advertising programs and services, level of market, and foreign currency risk.[26]

2.1.2.2. Application Example[27]

USD, a US corporation, is the exclusive distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. USD's total reported cost of goods sold is USD 800, consisting of USD 600 of property purchased from FP and USD 200 of other property purchased from unrelated parties. USD's applicable resale price and reported gross profit are as follows:

Resale Price	*USD 1000*
Cost of goods sold	
Cost of purchases from FP	600
Cost paid to unrelated parties	200
Reported gross profit	200
Gross Profit Margin	20%

Assume that USD earns a gross profit margin of 25% on its purchases from third parties and that these purchases are deemed to be comparable to the purchases that USD makes from FP. Based on this scenario, USD is over-paying FP since its reported gross margin of 20% is less than the arm's-length rate of 25%. To achieve a gross margin of 25%, the amount USD paid to FP would need to be reduced by USD 50, bringing its related party COGS to USD 550.

25. Treasury Regulation §1.482-3(c)(3)(ii)(A).
26. Treasury Regulation §1.482-3(c)(3)(ii)(C).
27. This section is based on the example(s) provided in Treasury Regulation §1.482-3(c)(4), though some facts may have been altered for clarity of the example.

Resale Price	*USD 1000*
Cost of goods sold	
Cost of purchases from FP	550
Cost paid to unrelated parties	200
Reported gross profit	250
Gross Profit Margin	25%

2.1.3. Cost Plus Method

2.1.3.1. Description

Typically used in circumstances where products are manufactured or assembled and then sold to related parties, the cost plus method evaluates the arm's-length nature of an intercompany charge by reference to the gross profit markup earned in CUTs. Under the cost plus method, an arm's-length price equals the controlled party's cost of producing the tangible property (classified as Costs of Goods Sold under US GAAP) plus an arm's-length markup.

Comparability under this method is most significantly affected by similarities in functions performed, risks borne, and contractual terms, or adjustments have to be made to reflect differences in these items. As in the case of the RPM, close physical similarity between products transferred in controlled and uncontrolled transactions is less important than under the CUP.[28] It is expected, however, that the compared products would fall within the same general product categories. Other factors that can influence comparability include the following: the complexity of manufacturing or assembly; manufacturing, production, and process engineering; procurement, purchasing, and inventory control; testing; selling, general, and administrative expenses; and foreign currency risks. Differences in the value of products due to trademarks, or other intangibles, might also affect the reliability of the comparison.[29]

2.1.3.2. Application Example[30]

USP, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. FS is responsible for assembly, and it owns valuable marketing intangibles. USP is chosen as the tested party since it does not own

28. Treasury Regulation §1.482-3(d)(3)(ii)(B).
29. Treasury Regulation §1.482-3(d)(3)(ii)(B).
30. This section is based on the example(s) provided in Treasury Regulation §1.482-3(d)(4), though some facts may have been altered for clarity of the example.

non-routine intangibles. UT1, UT2, and UT3 are also domestic computer component manufacturers that sell to uncontrolled foreign companies. Like USP, UT1, UT2, and UT3 produce similar products, own no non-routine intangibles, and have similar functional/risk profiles. Relatively complete data is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms associated with their product sales. In addition, data is available to ensure accounting consistency between all of the uncontrolled manufacturers and USP.

Given that there are no material differences between the controlled and uncontrolled transactions as described, the cost plus method can be used to evaluate the arm's-length nature of USP's charge to FS by reference to the gross profit markups earned by UT1, UT2, and UT3 in their respective sales to uncontrolled foreign companies.

2.2. Intangible Property Transactions Embedded Intangibles

Where intangible property, such as a trademark or trade name, is embedded with the transfer of a tangible product, the embedded intangible normally is not considered as a separate transfer unless the controlled purchaser acquires rights to exploit that intangible other than in connection with the resale of the tangible property.[31] However, an embedded intangible may affect value and therefore comparability with other tangible transactions.

Intercompany services transactions may also include an element constituting the transfer of intangible property. Similar rules also surround the evaluation of embedded intangibles in services transactions.[32] The methods prescribed under the US Regulations to evaluate services transactions are presented in section 2.3.

The final US regulations present four methods for testing arm's-length pricing for the transfer and use of intangible property. These methods include the CUT method, the CPM, the profit split method, and unspecified methods. These methods are discussed below.

2.2.1. Comparable Uncontrolled Transaction Method

2.2.1.1. Description

The CUT method evaluates the arm's-length nature of an intercompany charge by reference to CUTs. If an uncontrolled transaction involves the

31. Treasury Regulation §1.482-4(e) and §1.482-3(f).
32. Treasury Regulation §1.482-9(m).

transfer of the same intangible under the same (or substantially the same) circumstances as the controlled transaction, then this method will ordinarily provide the most reliable measure of an arm's-length charge. Circumstances are considered substantially the same if only minor, quantifiable differences exist for which appropriate adjustments can be made.

The intangible involved in the uncontrolled transaction is considered comparable to the controlled intangible when each has a similar profit potential, and each is used in connection with similar products or processes within the same general industry or market. Other factors to be considered are the terms of the transfer, the stage of development, rights to receive updates, revisions, or modifications, uniqueness of the property, duration of the license, economic and product liability risks, existence of collateral transactions, general economic conditions and functions performed by the transferor and transferee.[33]

2.2.1.2. Application Example[34]

USpharm, a US pharmaceutical company, develops a new drug Z which is a safe and effective treatment for the disease Zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory approvals necessary to market drug Z in the United States and in foreign countries.

USpharm licenses to its subsidiary in country X, Xpharm, the right to produce and sell drug Z in country X. At the same time, it licenses to an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighbouring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries and both countries provide similar protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income, health-care systems and the incidence of the disease Zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug Z in each country are expected to be approximately the same.

USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, to the terms established between USpharm and Ydrug. In this example, the two countries are sufficiently similar in demography and regulatory environments. Therefore, the CUT method is deemed to be the best method in this case. Therefore the royalty charged to

33. Treasury Regulation §1.482-4(c)(2)(iii)(B)(2)(vi).
34. This section is based on the example(s) provided in Treasury Regulation §1.482-4(c)(4), though some facts may have been altered for clarity of the example.

USpharm is considered arm's-length if it is consistent with the rate charged to Ydrug.

2.2.2. Comparable Profits Method

2.2.2.1. Description

The CPM evaluates a transfer price by referring to 'objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances' as the controlled taxpayer.[35] Profit-level indicators measure the relationship between profits and financial variables that would be expected to drive expected profits. Examples of profit level indicators include the ratio of operating profit to operating assets, the ratio of operating profit to sales, the ratio of gross profit to operating expenses, and other similar ratios.

Under the CPM, an arm's-length result is one where the selected profit level indicator of the 'tested party' is within the arm's-length range of comparable company profit level indicators. The tested party refers to the controlled party whose operating profit attributable to the controlled transaction can be verified using the most reliable data and requiring the fewest adjustments, and for which the most reliable uncontrolled data can be located. Usually, the tested party will not own valuable intangible property, and will be the least complex among the controlled group.[36]

Under this method, comparability is especially dependent upon resources employed, risks assumed, and functions undertaken. The degrees of both functional comparability and product comparability required between the controlled and uncontrolled taxpayer, however, are not generally as great as those mandated under the resale price or cost plus methods. Other factors influencing comparability might include varying cost structures and differences in management efficiency.[37]

The process of applying the CPM to intangible transactions is similar to an application to tangible transactions. In general, the CPM method determines a royalty payment by treating the licensee as the tested party, and then benchmarking the return to be earned by the tested party by comparison to comparable unrelated companies that similarly do not own non-routine intangible property. Any excess return earned by the tested party relative to the comparable unrelated parties is then determined to be due to the licensor in the form of an arm's-length royalty payment.

35. Treasury Regulation §1.482-5(a).
36. Treasury Regulation §1.482-5(b)(2)(i).
37. Treasury Regulation §1-482-5(c)(2)(iii).

2.2.2.2. Application Example[38]

FP is a publicly traded foreign corporation with a US subsidiary, USSub. FP manufactures a consumer product for worldwide distribution. USSub imports the assembled product and distributes it within the United States at the wholesale level under the FP name. FP does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none are sold to uncontrolled taxpayers or to uncontrolled distributors.

Based on all the facts and circumstances, the CPM is selected as the most reliable measure of an arm's-length result. USSub is selected as the tested party because it engages in activities that are less complex than those undertaken by FP. There are data from a number of independent operators of wholesale distribution businesses. These potential comparables are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to USSub. The ratio of operating profit to sales is selected as the most appropriate profit level indicator for comparison.

Information is sufficiently available to adjust for any material differences between USSub and the uncontrolled distributors. Therefore, the average ratio of operating profit to sales can be calculated for each of the uncontrolled distributors to establish an arm's-length range under the CPM.

2.2.3. Profit Split Method

2.2.3.1. Description

The profit split method evaluates the arm's-length nature of the allocation of combined operating profit (or loss) resulting from one or more intercompany transactions, based on the relative value of each controlled party's contribution to that operating profit (or loss). Contributions to operating profit (or loss) are determined according to the functions performed, risks assumed, and resources employed by each party.

The US regulations specify two types of profit split methods: the comparable profit split method and the residual profit split method. The comparable profit split method divides profits (or losses) from a controlled transaction according to the percentages of combined operating profit realized by parties in uncontrolled transaction that have functions, risks, and assets that are similar to the parties involved in the controlled transaction.[39]

38. This section is based on the example(s) provided in Treasury Regulation §1.482-5(e), though some facts may have been altered for clarity of the example.
39. Treasury Regulation §1.482-6(c)(2)(i).

The residual profit split employs a two-step process to allocate combined operating profits (or losses) among controlled parties. The first step provides a market return to each party's routine contributions to the relevant business activity. It references the returns earned by uncontrolled taxpayers engaged in similar activities, and applies these returns to the controlled parties. Next, where the controlled group owns non-routine intangible property, the residual profit is divided among the controlled taxpayers 'based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution'.[40] The determination of relative value is critical to the analysis and is potentially measured in a variety of ways, including the relative capitalized cost of developing each party's intangibles (less amortization), or through external market benchmarks.[41] Profit split is likely to be considered the best method when the parties conduct integrated activities characterized by centralized risk-management and personnel policies.

2.2.3.2. Application Example[42]

XYZ is a US corporation that develops, manufactures and markets a line of products for police use in the United States. XYZ's research unit developed a bullet-proof material for use in protective clothing and headgear (Nulon). XYZ obtains patent protection for the chemical formula for Nulon. Since its introduction in the United States, Nulon has captured a substantial share of the US market for bullet-proof material.

XYZ licenses the patent to its established European subsidiary, ESUB, which in turn performs R&D related to Nulon, develops a new application for military use and markets the adapted material through its marketing network using its own brand name. Without regard to any royalty payable to the US parent, the European subsidiary earns USD 200 million in operating profits on USD 500 million in gross sales of the material.

It is determined that the residual profit split method is the best method of analysis in this case. This is because unique and valuable intellectual property created by both parties is being used to generate the sales made to the military. To apply the residual profit split method in this case, an arm's-length return would first need to be established for ESUB to remunerate it for routine manufacturing and marketing activities. Once the routine return

40. Treasury Regulation §1.482-6(c)(3)(i)(B).
41. Treasury Regulation §1.482-6(c)(3)(i)(B).
42. This section is based on the example(s) provided in Treasury Regulation §1.482-6(c)(3)(iii), though some facts may have been altered for clarity of the example.

is determined, the residual profit would then be allocated to each of the parties based on the relative contribution of each party's intangibles.

The analysis performed determined that the routine return owed to ESUB is USD 20 million. Therefore the residual income to be allocated between the parties is USD 180 million. The table below illustrates the profit and loss statement, and how to arrive at the residual profit to be split.

Gross Sales	*USD 500*
Cost of goods sold	150
Gross Profit	350
R&D Expense	75
Marketing Expense	50
Other Operating Expenses	25
Operating Profit	200
10% Return to Routine Functions	20
Residual Profit to be split	USD 180

In the analysis performed, it is determined that R&D expenditure is a good proxy for relative value created by each party's intangible assets. Therefore, the residual profit can be allocated based on the relative capitalized and amortized value of each party's research and development expenses. The US parent's capitalized research and development expenditures are equal to USD 20 million (or one-third of the total expenditures), while the European subsidiary's capitalized research and development expenditures are equal to USD 40 million (two-thirds of the total expenditures). Based on their relative R&D value, the US parent should be allocated USD 60 million (33.3% × USD 180 million) of the residual intangible profits, and the European subsidiary should be allocated USD 120 million (66.6% × USD 180 million) of the residual profits.

2.2.4. Unspecified Method

A method not specified in the regulations may be used if it 'provides the most reliable measure of an arm's-length result'[43]

An unspecified method should take into account that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none

43. Treasury Regulation §1.482-3(e).

of the alternatives is preferable to it.[44] For example, the CUP method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's-length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.[45]

2.3. Service Transactions

On 31 July 2009, the IRS and Treasury Department issued final regulations under section 482 on taxable income in connection with a controlled services transaction ('Service Regulations').[46] The regulations apply to 'all controlled services transactions'. A 'controlled services transaction' includes any activity by one controlled taxpayer that would result in a benefit to one or more other controlled taxpayers.[47] The term 'activity' is defined broadly to include the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances.[48]

The regulations stress the presence of a more than remote or unduly indirect benefit to the recipient in consideration for intercompany services.[49] However, the regulations replaced the provisions in Treasury Regulation §1.482-2(b)(i) with provisions that determine the presence of a benefit from the viewpoint of the recipient. Thus, the regulations generally provide that an activity is considered to confer a benefit sufficient to give rise to a controlled service transaction if an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity, or would be willing to perform for itself the same or similar activity. Treasury Regulation §1.482-9(l)(3) indicates, for example, that stewardship expenses do not provide a benefit (and therefore avoid an intercompany service charge) only if the activity is duplicative of an activity performed by another controlled taxpayer, or if the sole effect of the

44. Treasury Regulation §1.482-3(e).
45. Treasury Regulation §1.482-3(e).
46. The final regulations replaced Treasury Regulation §1.482-9T (temporary regulations), although with only minor modifications of the temporary regulations.
47. Treasury Regulation §1.482-9(l)(1).
48. Treasury Regulation §1.482-9(l)(2).
49. Treasury Regulation §1.482-9(l)(3).

services is to protect the renderer's capital investment in the recipient or in other members of the controlled group, and/or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer.

Treasury Regulation §1.482-9(a) specifies six transfer pricing methods (TPMs) for controlled party services. One of the methods is the services cost method (SCM) that, in part, replaces the cost-only safe harbour, three are traditional transactional methods, and two are profit-based methods. The six methods are:[50]

- the Comparable Uncontrolled Services Price (CUSP) method, which is analogous to the CUP method applicable to transfers of tangible property;
- the Gross Services Margin method (GSMM), which is analogous to the RPM applicable to transfers of tangible property;
- the Cost of Services Plus method, which is analogous to the Cost Plus method applicable to transfers of tangible property;
- the SCM, which in part replaces the cost safe harbour for non-integral services, and in limited circumstances permits taxpayers to price services at total services cost of uncontrolled taxpayers that performed similar services under similar circumstances without risking IRS imputation of a markup;
- the Comparable Profits method; and
- the profit split method.

The regulations also allow for unspecified methods, provided that (as with the six methods above) the taxpayer can provide information about realistic alternatives to the controlled services transaction that were considered, and can demonstrate that the method used gives the most reliable measure of an arm's-length result under the principles of the best-method rule.[51]

Note that transactions that are not structured as controlled services transactions, but may include elements of controlled services transactions, are generally evaluated under the single TPM that most reliably measures the arm's-length result.[52] These transactions need not be separately evaluated element-by-element if sufficiently comparable uncontrolled integrated transactions are available as benchmarks.

50. Treasury Regulation §1.482-9(b)-(g).
51. Treasury Regulation §1.482-9(h).
52. Treasury Regulation §1.482-9(m)(4).

2.3.1. Services Cost Method

2.3.1.1. Description

The SCM is an elective method, which allows for services to be charged at cost if three conditions are met. First, the services in question must be routine in nature. Services that 'contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in the business of the renderer, recipient, or both'[53] do not qualify for the SCM (referred to as the business judgment rule). Second, the services in question are not an excluded service as defined in the regulations. The Service Regulations provide a list of services that are specifically excluded from being charged out at cost under the SCM. These services include manufacturing, production, extraction/exploration/processing of natural resources, construction, reselling/distributing/acting as a sales or purchasing agent, research/development/experimentation, engineering, financial transactions (including guarantees), and insurance or reinsurance.[54] Third, the activity must qualify as either:

(1) Specified Covered Service: A taxpayer must match the tested service to a list of 20 service categories and 101 service activities assembled by the IRS;[55] or
(2) Low Margin Covered Service: A taxpayer must determine that the service has a median arm's-length markup on total services costs of less than or equal to 7%, as determined by independent comparables.[56]

If the service meets all three criteria, then a taxpayer may elect to charge for the service at cost. That is, the SCM will be considered the best method of analysis.[57] In addition, a taxpayer must include in its books and records a statement evidencing the intention to apply the SCM to the services in question.[58]

2.3.1.2. Application Example[59]

Company P (a US company) and its subsidiaries, Company Q and Company R, are corporations and members of the same group of controlled entities

53. Treasury Regulation §1.482-9(b)(2).
54. Treasury Regulation §1.482-9(b)(3)(ii).
55. Internal Revenue Bulletin: 2007-3, Notice 2007-5 and Revenue Procedure 2007-13.
56. Treasury Regulation §1.482-9(b)(4)(ii).
57. Taxpayers are not precluded from adding an arm's length markup to the cost of services that may otherwise qualify for the SCM. In such instances, the SCM is not considered the best method of analysis and other methods must be evaluated.
58. Treasury Regulation §1.482-9(b)(3)(i).
59. This section is based on the example(s) provided in Treasury Regulation §1.482-9(b)(8), though some facts may have been altered for clarity of the example.

(PQR Controlled Group). Company P, Company Q, and Company R own and operate hospitals. Each owns an electronic database of medical information gathered by doctors and nurses during interviews and treatment of its patients. All three databases are maintained and updated by Company P's administrative support employees who perform data entry activities by entering medical information from the paper records of Company P, Company Q, and Company R into their respective databases.

The service provided by Company P to its affiliates is a 'covered service'.[60] In addition, this administrative function is deemed to be routine in nature by applying the business judgment rule. Therefore, Company P may elect to charge for its data entry services at cost.

2.3.2. Comparable Uncontrolled Services Price Method (CUSP)

2.3.2.1. Description

The CUSP Method 'evaluates whether the amount charged in a controlled services transaction is arm's-length by reference to the amount charged in a comparable uncontrolled services transaction'.[61] When assessing the factors affecting the degree of comparability between controlled and uncontrolled services transactions, similarity of services performed generally will have the greatest relevance. Where there are material differences for which adjustments cannot be made, this method ordinarily will not qualify as the best method.[62] The close similarity of contractual terms and economic conditions is also highly important for establishing comparability. This methodology is analogous to the CUP and CUT methodologies for tangible and intangible property methods, respectively.

2.3.2.2. Application Example[63]

Company A, a US corporation, performs shipping, cargo-loading, and related services for controlled and uncontrolled parties on a short-term or as-needed basis. Company A charges uncontrolled parties in Country X a uniform fee of USD 60 per container to place loaded cargo containers in Country X on ocean-going vessels for marine transportation. Company A also performs identical services in Country X for its wholly-owned subsidiary, Company B, and there are no substantial differences between the controlled and uncontrolled

60. Rev. Proc. 2007-13, activity 14.
61. Treasury Regulation §1.482-9(c)(1).
62. Treasury Regulation §1.482-9(c)(2)(ii).
63. This section is based on the example(s) provided in Treasury Regulation §1.482-9(c)(4), though some facts may have been altered for clarity of the example.

transactions. Because Company A renders substantially identical services in Country X to both controlled and uncontrolled parties, it is determined that the CUSP constitutes the best method for determining the arm's-length price for the controlled services transaction. Based on the reliable data provided by Company A concerning the price charged for services in CUTs, a loading charge of USD 60 per cargo container will be considered the most reliable measure of the arm's-length price for the services rendered to Company B.

2.3.3. Gross Services Margin Method

2.3.3.1. Description

The GSMM relies upon an analysis of the gross profit margins earned in comparable uncontrolled services transactions to test the arm's-length nature of charges in a controlled services transaction. It measures the value of functions performed, and is frequently employed in cases where a controlled taxpayer performs services for a member of the controlled group in connection with a transaction between that member of the controlled group and an uncontrolled taxpayer. The method may also be used when a controlled taxpayer contracts to provide services to an uncontrolled taxpayer, and another member of the controlled group performs the services.[64]

2.3.3.2. Application Example[65]

Company A and Company B are members of a controlled group. Company A is a US corporation that sells computer consulting services to a third party. Company B, a Country X subsidiary of Company A, executes the consulting services which Company A sells to business clients, such as systems integration and networking. Company A retains a portion of the revenue, which it books for obtaining the sale, and pays the remainder to Company B for providing the services. The compensation Company B receives is determined by setting a gross margin equal to the gross margin earned by comparable companies performing similar services.[66]

64. Treasury Regulation §1.482-9(d)(2)(iv).
65. This section is based on the example(s) provided in Treasury Regulation §1.482-9(d)(4), though some facts may have been altered for clarity of the example.
66. This section is based on the example(s) provided in Treasury Regulation §1.482-9(e)(4), though some facts may have been altered for clarity of the example.

2.3.4. Cost of Services Plus Method

2.3.4.1. Description

The Cost of Services Plus method evaluates the transfer price by referring to the gross services profit markup realized in CUTs. This method is typically used in circumstances where the same or similar services are performed for both uncontrolled and controlled parties. This method is not generally used when controlled services transactions are contingent on a payment. Under the Cost of Services method, an arm's-length price is measured by adding the appropriate gross services profit to the controlled taxpayer's comparable transactional costs.

2.3.4.2. Application Example

Company A designs and assembles information-technology networks and systems. When Company A renders services to uncontrolled parties, it receives compensation based on time and materials as well as certain other related costs necessary to complete the project. Reliable accounting records maintained by Company A indicate that Company A earned a gross services profit markup of 10% on its total costs incurred in providing design services during the year under examination. The services were rendered on information technology projects for uncontrolled entities.

Company A designed an information-technology network for its Country X subsidiary, Company B. The services rendered to Company B are similar in scope and complexity to services that Company A rendered to uncontrolled parties during the year under examination. Using Company A's accounting records, it is possible to identify the comparable transactional costs involved in the controlled services transaction on a basis that is consistent with the identification of costs born by Company A in rendering similar design services to uncontrolled parties. Company A's records indicate that it does not incur any additional types of costs in rendering similar services to uncontrolled customers. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on the gross services profit markup data derived from Company A's uncontrolled transactions involving similar design services, an arm's-length result for the controlled services transaction is equal to the price that will allow Company A to earn a 10% gross services profit markup on its comparable transactional costs.

2.3.5. Comparable Profits Method (CPM)

2.3.5.1. Description

As discussed previously for tangible and intangible property transactions, the CPM determines an arm's-length price by reference to a measure of profitability of unrelated companies that engage in similar activities under similar circumstances.[67] It is typically the case that the profit level indicator used in applying a services-related CPM is a markup on total costs. Specifically, the regulations state that, 'a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs'.[68]

2.3.5.2. Application Example[69]

Company A, a parent corporation in country T, and its foreign subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain research and development services on its own behalf and, on a contract basis, on behalf of its affiliates, including Company B. It does not provide research and development services to third parties. No external CUPs are available to use as benchmarks.

Based on the facts and circumstances, it is determined that the CPM will provide the most reliable measure of an arm's-length result. Company A is selected as the tested party. Financial data are available for ten independent firms that render similar research and development services as their principal business activity in Country T. Neither Company A nor the comparable companies use valuable intangible property in rendering the services. Based on the available financial data of the comparable companies, it cannot be determined whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies. Therefore, the average ratio of

67. Treasury Regulation §1.482-9(f)(1).
68. Treasury Regulation §1.482-9(f)(2)(ii).
69. This section is based on the example(s) provided in Treasury Regulation §1.482-9(f)(4), though some facts may have been altered for clarity of the example.

operating profits to total services costs can be calculated for each of the uncontrolled service providers to establish an arm's-length range under the CPM and compare to the average results of Company A.

2.3.6. Profit Split Method

2.3.6.1. Description

Similar to the tangible and intangible transactions sections above, the application of the Profit split method for a service transaction determines an arm's-length transfer price on the basis of the relative value of each controlled taxpayer's contributions to the combined operating profit or loss.[70]

2.3.6.2. Application Example[71]

Company A, a corporation resident in Country X, auctions spare parts by means of an interactive database. Company A developed and continues to maintain the software used to run the database. Company A's database is managed by Company A employees in a data centre located in Country X. Company A has a wholly-owned subsidiary, Company B, located in Country Y. Company B provides sales, marketing and IT services that help to promote Company A's interactive database. Company B solicits companies to auction spare parts on Company A's database, and solicits customers interested in purchasing spare parts online.

In order to facilitate these services, Company B developed a specialized communications network. Utilizing the network, Company B receives information on spare parts available for auction in real time and streams this data to Company A's data centre in Country X. Company B's communications network also allows companies to access Company A's interactive database and purchase spare parts.

Analysis of the facts and circumstances indicates that both Company A and Company B possess valuable intangible property that is integral to the success of the company's spare-parts auction business. Company A bore the business risk associated with developing and maintaining the software and the interactive database. Company B bore the business risk associated with developing the necessary technology that it utilizes when providing sales and marketing services related to collecting and transmitting information to Company A's data centre and to allow potential customers access to Company A's interactive database. Therefore, when pricing the services that Company B provides to Company A, one needs to recognize that the services are being performed

70. Treasury Regulation §1.482-9(g)(1).
71. This section is based on the example(s) provided in Treasury Regulation §1.482-9(g)(2), though some facts may have been altered for clarity of the example.

using Company B's 'non-routine' contribution (i.e., the specialized communications network). Given these facts, the profit split method will likely provide the most reliable measure of an arm's-length result. As none of the services described above are routine in nature, the total profit should be split based on each party's full operating costs, including capitalized research and development expense to arrive at an arm's-length result.

2.4. Loans

2.4.1. Description

Determining the arm's-length nature of intercompany loans is addressed as a 'specific situation' in Treasury Regulation §1.482-2(a), which states that a loaning entity must charge an arm's-length rate of interest to a related party for loans or advances. It is specifically noted that the arm's-length rate of interest should be charged on the principal amount of a bona fide indebtedness,[72] including the following:

(1) loans or advances of money or other consideration (whether or not evidenced by a written instrument);[73] and
(2) indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.[74]

The arm's-length rate of interest should be the interest rate that would have been charged, at the time the indebtedness took place, in an independent transaction under similar circumstances. When determining a comparable arm's-length interest rate, taxpayers should consider a number of factors, including the principal amount borrowed and the duration of the loan, security involved, credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between related parties.[75] If the loan or advance represents the proceeds of a loan borrowed by the lender at the situs of the borrower, the interest rate paid by the lender increased by an amount that represents the costs incurred by the lender in borrowing such amounts represents an appropriate arm's-length rate.[76]

Generally, when a loan or advance is made, interest should be charged beginning on the day after the loan or advance is made, and should end on

72. Treasury Regulation §1.482-2(a) does not apply to alleged indebtedness which is not a bona fide indebtedness, even if the interest would be within the safe haven rates. It does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property.
73. Treasury Regulation §1.482-2(a)(1)(ii)(A)(1).
74. Treasury Regulation §1.482-2(a)(1)(ii)(A)(2).
75. Treasury Regulation §1.482-2(a)(2)(i).
76. Treasury Regulation §1.482-2(a)(2)(ii).

the day the loan or advance is satisfied. However, for intercompany trade receivables there is an interest free period. When trade receivables arise during the ordinary course of business, interest is not required to be charged until the 'first day of the fourth calendar month following the month in which such intercompany trade receivable arises'.[77]

In addition, if, as a regular trade practice in the industry in which the creditor operates, the creditor or other unrelated persons in the industry allow unrelated parties a longer period without charging interest with respect to the transactions that are similar to the controlled transactions, such longer interest-free period shall be allowed.

For term loans or advances made between members of a group of controlled entities, or a demand loan or advance made between such controlled entities after 8 May 1986, safe haven interest rates can be used to determine the arm's-length interest rate at the option of the taxpayer. When applying the safe haven, the interest rate is determined to be arm's-length if the rate of interest actually charged is not less than 100% of the applicable federal rate (AFR), and not greater than 130% of the AFR. The AFR is determined by the term length of the transaction in question. For loans with a term of:

- three years or less, the Federal short-term rate applies;
- for a term of over three years but not over nine years, the Federal mid-term rate applies; and
- for a term over nine years, the Federal long-term rate in effect on the date such loan or advance is made applies.[78]

However, if the lender is regularly engaged in the business of making loans or advances to unrelated parties, the safe haven interest rates should not be used. Instead the arm's-length interest rate should be determined with reference to the interest rates charged in such trade or business by the lender on loans or advances of a similar type made to unrelated parties at and about the time the loan or advance was made. Additionally, the safe haven interest rates do not apply to a loan or advance when the principal or interest is expressed in a currency other than US dollars.

2.4.2. Application Example

Assume a related party demand loan of USD 100,000 arises. The taxpayer chooses to use the safe haven interest rates to determine the arm's-length nature of the related party loan. Therefore, the interest rate should fall within the range from 100% to 130% of the applicable AFR to be considered

77. Treasury Regulation §1.482-2(a)(1)(iii)(C).
78. Treasury Regulation §1.482-2(a)(2)(iii)(C)(1)-(3).

arm's-length. The lender charges the controlled borrower 5% simple interest. The short-term AFR in effect is 4%. Therefore, an arm's-length amount of interest to be charged on the demand loan is between 4% and 5.2% (100%–130% of the applicable AFR). The 5% interest charged by the lender to the controlled borrower is within this range, and is therefore considered arm's-length under the safe harbour provisions.

2.5. Cost Sharing

The US transfer pricing regulations contain special provisions for cost sharing. In general, cost sharing is intended to allow two or more related parties to share both the risks and rewards of specific intangible development activities (IDAs). Cost sharing offers taxpayers an alternative to other forms of intangible rights transfers, such as the license of intangible property.

At a high level, taxpayers who wish to enter into a cost sharing arrangement execute an agreement between two or more related parties. Under the agreement, the participants agree to share the costs of IDAs in proportion to their expected shares of reasonably anticipated benefits (RABs) derived from the developed intangibles. Conceptually, for a cost sharing arrangement to occur at arm's-length, several questions must be addressed. These questions include:

- What intangibles are to be shared and developed under the cost sharing arrangement?
- What are the IDAs that will be undertaken in order to maintain or develop the cost shared intangibles?
- What, if any, upfront consideration should be paid to any of the participants contributing pre-existing intangibles to the arrangement?
- How should the cost pool that will be subject to sharing under the CSA be determined?
- How should the cost pool be split among the participants (i.e., what are the RAB shares)?

The cost sharing regulations under section 482 address these questions by providing regulatory guidance to taxpayers. This guidance has been subject to much change and debate. The evolution of the cost sharing regulations is discussed in more detail below.

2.5.1. Evolution of the Regulations

The 'old' cost sharing provisions embodied in Treasury Regulation §1.482-7 provided guidance for taxpayers wishing to enter into intercompany-qualified CSAs starting in taxable years that began on or after 1 January 1996.

As such arrangements were reviewed under audit, the IRS became increasingly concerned with what it perceived to be abusive cost sharing practices, especially as they related to taxpayer's determination of appropriate buy-in payments for pre-existing intangibles. On 24 August 2005, the IRS released new proposed cost sharing regulations. The preamble to the proposed regulations made it clear that the IRS viewed many of the proposed regulations (and particularly, the income method that the proposed regulations specified for determining arm's-length buy-in payments) as merely clarifying the intent of the original cost sharing regulations, although the new regulations contained far more detailed guidance and introduced new conceptual frameworks.

On 27 September 2007, the IRS issued a Coordinated Issue Paper (CIP) on section 482 CSA buy-in adjustments. This CIP stated that IRS auditors should evaluate cost sharing buy-in payments using the income method (largely similar to that in the proposed cost sharing regulations) or, in the case of post-CSA-formation buy-ins, the acquisition price method (also presented in the proposed regulations). This CIP made it clear that one of these methods would be considered the best method of analysis in most cases, even though they were not specified methods under the original guidance for buy-ins in the regulations that were still in effect at that time.

On 31 December 2008, new temporary regulations were issued that largely adopted the provisions of the proposed regulations, with a few notable exceptions. The remainder of this section will provide an overview of the prior regulations (which were effective for cost sharing and buy-in transactions occurring prior to 4 January 2009) as well as the new temporary regulations.

2.5.2. Pre 4 January 2009 Regulations

2.5.2.1. Buy-In Payments for Pre-existing IP

CSAs typically cover intangible development programs that utilize pre-existing intangibles contributed by one or more of the participants at the onset of the arrangement. When a controlled participant makes pre-existing intellectual property available to other controlled participants through a qualified CSA, the other participants must compensate the controlled participant for its contribution. This compensation was referred to as a 'buy-in payment' and was introduced in Treasury Regulation §1.482-7(g). The original guidance for determining an arm's-length buy-in payment simply held that payments should be determined in a manner consistent with the guidance for pricing intangible transactions, as specified in Treasury Regulation §1.482-1 and §1.482-4 through §1.482-6. In practice, the residual profit split method combined with a declining royalty approach was the most commonly used

method in determining an arm's-length buy-in under the old cost sharing regulations.[79]

2.5.2.2. Determination and Allocation of Cost Pools

Once the intangibles to be developed under the cost sharing agreement were identified, Treasury Regulation §1.482-7 provided rules for determining each controlled participant's share of the costs of intangible development. Specifically, each participant's share of the cost needed to be commensurate with its RABs relative to the group's benefit. As stated earlier, each participant's share of the costs was referred to as its RAB share.

To determine each participant's RAB share, the taxpayer had to reliably estimate anticipated benefits. The anticipated benefits needed to be measured on the most reliable measure, whether it is a direct or indirect basis.[80] Projections used to estimate anticipated benefits needed to consider the time over which the benefits would accrue.[81] Given that the determination of each participant's RAB share was often based on taxpayer generated projections, the reliability of the RAB share determination is highly dependent on the accuracy of those projections. To address concerns that taxpayers might manipulate projections to achieve desired tax results (and given that the IRS did not have the same level of knowledge about the origins and legitimacy of the projections), the IRS retained the right to make RAB share adjustments if it was deemed that the method used to estimate benefit was not the best method, or if the divergence between actual benefits and the projections was greater than 20%.[82]

2.5.2.3. Documentation and Administrative Requirements

In addition to a legal agreement between the parties, annual documentation needed to be maintained by the taxpayer that supported the arm's-length nature of its cost sharing arrangement. Specifically, the documentation needed to address the amount and sharing of the intangible development costs, the accounting standards used in any analyses, and support for any buy-in payments made by the parties.

79. With the declining royalty method, starting values of the buy-in royalty were established either through a CPM or through a CUT analysis. The royalty was then declined over what was argued to be the useful life of the intangible assuming no additional R&D was performed.
80. Anticipated benefits are measured on a direct basis, by reference to estimated additional income to be generated or costs to be saved by the use of the covered intangibles, or on an indirect basis. Anticipated benefits measured on an indirect basis may be measured on units used, produced or sold, sales, operating profit, or other bases. Each indirect basis must reasonably identify the relationship between the basis and additional income generated or costs saved by use of the covered intangibles. (Treasury Regulation §1.482-7(e)).
81. Treasury Regulation §1.482-7(f)(3)(ii).
82. In theory, the district director would not make such an adjustment if the taxpayer could demonstrate that the divergence was due to unforeseeable events.

Unlike other transfer pricing documentation requirements, the taxpayer was also required to attach to its US tax return a statement indicating that it was a participant in a qualified cost sharing arrangement, and listing the other participants to the agreement.

2.5.3. Regulations as of 4 January 2009

As stated, most of the new temporary regulations are meant to more clearly codify the intent of the old cost sharing regulations, but rely heavily on the 'investor model' framework, a framework first introduced in the 2005 proposed regulations. This framework holds that at the commencement of a transfer of pre-existing intangibles, all participants should expect to earn a return on their total investments that is appropriate given the risk associated with each participant's activity under the CSA. In addition, the regulations rely upon the 'realistic alternatives' concept that states that uncontrolled taxpayers dealing at arm's-length would evaluate the terms of the cost sharing arrangement and would only enter into that transaction if there is no preferable alternative. The introduction of these concepts precluded the use of old methodologies that the IRS perceived were rewarding new participants (i.e., the participants with no pre-existing intangibles at the time that the arrangement was entered into) with unrealistically high expected returns.

2.5.3.1. Payments Made for Pre-existing IP

Under the new regulations, the contributions of pre-existing intangibles (or, more broadly, any contributions of a non-routine nature) are referred to as 'platform contribution transactions' (PCTs) and are similar in concept to what was referred to as 'buy-in payments' under the prior regulations. Like buy-in payments, PCT payments must be made as soon as the cost sharing agreement commences, or as soon as it is reasonably anticipated that a platform contribution will contribute to developing cost shared intangibles.

Unlike buy-in payments, which were generally thought of as payments for pre-existing technology and/or certain marketing intangibles, PCTs are explicitly required to cover all non-routine contributions by each party. Examples of non-routine contributions could include the contribution of a non-routine research and development workforce, market networks, and manufacturing 'know how'.

Once all of the pre-existing contributions have been identified, the regulations present specified methods for quantifying the required consideration. These methods are:

- the CUT method;
- the income method;
- the acquisition price method;

– the market capitalization method;
– the residual profit split method; and
– other unspecified methods.

To reliably use the CUT method in determining the value of a PCT, taxpayers should review potential CUTs to ensure that there is comparability between what is licensed in the uncontrolled transaction and what is contributed through the PCT, as well as the relative rights of each of the participants. In addition, other contractual and economic terms need to be considered, including the degree to which the allocation of risks between the unrelated parties is comparable to the relative risks of the cost sharing participants, and whether the potential CUT is comparable in scope, uncertainty, and profit potential.[83]

The income method is used when only one participant makes platform contributions (referred to by some as 'cash box' cost sharing structures because some participants (i.e. the 'cash boxes') are only contributing funding at the outset). The income method effectively calculates an arm's-length return for the 'cash box' participants for their routine functions, contributions, and investments, and allocates the expected non-routine returns to the participant making the platform contribution. The routine returns are typically determined using the taxpayer's income projections coupled with comparable data on returns earned for different activities.[84]

The acquisition price method will typically be used only when platform contributions are acquired as part of an acquisition after the formation of the CSA, and when substantially all of the acquired company's non-routine intangibles are contributed to the CSA. Under this method, the value of the PCT is determined by isolating the portion of the acquisition consideration associated with the platform contributions in question from the target's net tangible assets and non-compensable contributions.[85]

The market capitalization method will typically be used only when substantially all of a public company's non-routine intangible assets are contributed to the participants of a cost sharing agreement. Under this scenario, the value of the platform contributions is determined by isolating the portion of the company's market capitalization associated with the platform contributions from the company's net tangible assets and non-compensable contributions.[86]

The residual profit split method will ordinarily be used when multiple parties make significant non-routine contributions to the CSA. The application of this method, as in its other applications, first allocates routine returns to each participant for its routine contributions and then allocates any residual to the participants based on the relative value of each party's contribution. In a

83. Treasury Regulation §1.482-7T(g)(3).
84. Treasury Regulation §1.482-7T(g)(4). The regulations also stress the importance of supporting selected discount rates used in any net present value calculations.
85. Treasury Regulation §1.482-7T(g)(5).
86. Treasury Regulation §1.482-7T(g)(6).

cost sharing context, the overall return is typically estimated based on income or cash flow projections. It is similar to the income method except for the fact that more than one party to the agreement shares in the estimated benefit derived from the contribution of pre-existing intangibles.[87]

As with all transfer pricing methodologies, the choice of method must meet the best method standard and supporting methodologies, where possible, are encouraged.

2.5.3.2. Determination and Allocation of Cost Pools

The new cost sharing regulations provide more detailed rules associated with determining each participant's share of intangible development costs. To determine the appropriate pool of costs to be shared, all non-routine contributions and their associated intangible development costs must be identified. Intangible development costs are a result of any and all activities that could reasonably be expected to contribute to developing the shared intangibles.[88] Taxpayers should be aware that failure to define all IDAs and their associated costs may lead to material income adjustments and in the extreme, a re-characterization of the CSA (i.e., the IRS may argue that the arrangement is not in fact a CSA).

As in the prior regulations, RAB shares for each participant must be commensurate with each party's relative anticipated benefit. Benefits should be measured over the entire time period that the cost shared intangibles are expected to yield benefits to the participants. Unlike the 'old' cost sharing regulations, this benefit period should include not only prospective benefit, but also should incorporate actual benefits accrued since the inception of the cost sharing agreement. Anticipated benefit measures are largely unchanged from the old regulations, and include additional income to be generated or costs to be saved, units, operating profits, or other bases.[89]

2.5.3.3. Periodic Adjustments

Periodic adjustments may be made to cost sharing payments and PCT payments. The IRS may adjust a US taxpayer's taxable income if:

- it believes that the IDC pool should be adjusted;
- it believes that there is a better method for measuring RAB shares;
- the reliability of projections is called into question; or
- there is disagreement over the choice of best method for the purpose of valuing PCTs.

87. Treasury Regulation §1.482-7T(g)(7).
88. Intangible development costs must include all appropriate costs, fully burdened, including stock-based compensation.
89. Current shares may be used if the relative benefits are expected to be the same for all participants over time.

In addition, PCT payment adjustments may be made by the IRS if it is determined that controlled participants have realized rates of return (known as the 'Actually Experienced Return Ratios' or 'AERRs') that are outside a range of acceptable variance (known as the 'Periodic Return Ratio Range' or 'PRRR'). No adjustment will be made if:

- the PCT payment was determined using an acceptable CUT;
- the difference occurred due to extraordinary events outside of the control of the participants that could not have been reasonably anticipated as of the date of the PCT;
- if the AERR exceeds the bounds strictly because of functional returns;
- if the AERR would not be below the bounds if future expectations (as of the adjustment date) were incorporated into the numerator and denominator;
- for any year after the initial ten-year period following the start of any substantial exploitation of the intangibles developed under the CSA, provided that the AERR is within the PRRR for each of the initial ten years; or
- for any years in the first five years following substantial exploitation of cost shared intangibles for which the AERR falls below the lower bound of the PRRR.

Once an adjustment is triggered, the participants will be 'locked in' to a typically tax-disadvantageous, fixed profit split amongst the parties for the remainder of the CSA.

2.5.3.4. Documentation and Administrative Requirements

The new cost sharing regulations are significantly more administratively burdensome on the taxpayer than was the case under the prior rules. The new regulations articulate in great detail various elements that must be included in cost sharing agreements. The elements are discussed in detail in Treasury Regulation §1.482-7T(1)(ii)A-K. In addition to specific requirements for legal agreements, there is also an increased burden related to other documentation requirements, including descriptions of the current scope of the IDA, the benefits each controlled participant is expected to receive, the amount of each controlled participant's IDCs for each taxable year under the CSA, the method used to estimate each controlled participant's RAB share, and a description of all platform contributions and the method selected to determine the arm's-length payment due under each PCT. The required elements of transfer pricing documentation are detailed in Treasury Regulation 1.481-7T(2)(ii)A-G.

Finally, as in the prior regulations, the taxpayer is also required to attach to its US tax return a statement indicating that it was a participant in a cost sharing arrangement.

3. PENALTIES FOR NON-COMPLIANCE

3.1. US Transfer Pricing Documentation Requirements

The required documentation can be divided into two categories. The first category consists of what are referred to as 'Principal Documents'. The collection of Principal Documents is what is typically understood by taxpayers and practitioners to be included within an annual transfer pricing US documentation study.

Specifically, these Principal Documents are:

(1) 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;
(2) A description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;
(3) Any documentation explicitly required by the regulations under section 482, such as for substantiation of a market share strategy or documentation required for cost sharing arrangements;
(4) A description of the method selected and an explanation of why that method was selected;
(5) A description of the alternative methods that were considered and an explanation of why they were not selected;
(6) A description of the controlled transactions (including the terms of sale) and any internal data used to analyse those transactions. For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity;
(7) A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;
(8) An explanation of the economic analysis and projections relied upon in developing the method. For example, if a profit split method is applied, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits would be split;
(9) A description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and

(10) A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.[90]

The second category of documents is referred to as 'Background Documents'. Background documents are those documents that support '[t]he assumptions, conclusions, and positions contained in the principal documents'.[91] Examples of background documents include accounting records, legal agreements, and financial projections.

Under audit, taxpayers must produce their ten principal documents within thirty days of request. After reviewing a taxpayer's principal documents, the Service may also request a copy of its background documents. Similarly, these documents must be provided to the IRS within thirty days upon request, unless, at the director's discretion, this period is extended.

3.2. US Transfer Pricing Penalty Framework

The IRS has specific penalty rules relating to transfer pricing misstatements. Section 6662 encompasses these rules; it has been in effect since 9 February 1996. However, a taxpayer can voluntarily apply these rules to open taxable years that begin after 31 December 1993. Specifically, section 6662 presents two types of penalties. The first type of penalty is a transactional penalty and the second type is a net adjustment penalty. For each type of penalty, the regulations allow for either a 'substantial' or a 'gross' misstatement penalty depending on the severity of the tax misstatement. In this chapter, the penalties for transfer pricing non-compliance are discussed in detail.

3.2.1. Reported Results

Determination of whether a penalty will apply to any adjustment begins with the information on results reported on the US tax return. The transaction price that is determined by the taxpayer and represented on the tax return is subject to review by the IRS. Treasury Regulation §1.6662-6(a)(2) states:

> Whether an underpayment is attributable to a substantial or gross valuation misstatement must be determined from the results of controlled transactions that are reported on an income tax return, regardless of whether the amount reported differs from the transaction price initially reflected in the taxpayer's books and records.

90. Treasury Regulation §1.6662-6(d)(2)(iii)(B).
91. Treasury Regulation §6662-6(d)(2)(iii)(C).

If the taxpayer determines that a correction is needed related to the reported results on the original income tax return, an amended return can be filed, effectively replacing the initial filing. However, the amended return may only be used if that submission occurs prior to the IRS contacting the taxpayer regarding the original return. An amended return may also include a written statement provided to the IRS by a taxpayer involved in a coordinated examination program, accelerated issue resolution, or similar procedures if it either meets the requirements of a qualified amended return under Treasury Regulation §1.6664-2(c)(3)[92] or such requirements as the Commissioner may prescribe by revenue procedure. If the taxpayer is part of a consolidated entity income tax return, these rules would apply to the consolidated income tax return. In addition, section 482 states that an amended return may not be used if that submission decreases the amount of taxable income due by the taxpayer. More specifically, Treasury Regulation §1.482-1(a)(3) states: '. . . no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions'.

3.2.2. The Transactional Penalty

A transactional penalty is one of two types of penalties established in Treasury Regulation §1.6662-6. Conceptually, this penalty is applicable if the taxpayer's transfer prices are over- or under-stated by certain relative thresholds (in percentage terms). Therefore, a transactional penalty may be triggered even if, on an absolute dollar basis, the IRS initiated adjustment is relatively small. Under the Transactional Penalty, the regulations allow for either a 'substantial' or a 'gross' misstatement penalty depending on the severity of the tax misstatement. The penalties and thresholds related to substantial and gross valuation misstatements are further described below.

3.2.2.1. Substantial Valuation Misstatement

The transactional penalty has a two-tiered structure, where the severity of the penalty is tied to the relative size of the transfer price misstatement. The less severe transactional penalty occurs when there is a substantial valuation misstatement. 'In the case of any transaction between related persons, there is a substantial valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 200% or more (or 50% or less)

92. A qualified amended return is an amended return, or a timely request for an administrative adjustment under Treasury Regulation 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) – <www.taxalmanac.org>.

of the amount determined under section 482 to be the correct price.'[93] Under the transactional penalty framework, if there is a substantial valuation misstatement, the applicable penalty is 20% of the underpayment of tax.

3.2.2.2. Gross Valuation Misstatement

The more severe transactional penalty occurs when there is a gross valuation misstatement. 'In the case of any transaction between related persons, there is a gross valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 400% or more (or 25% or less) of the amount determined under section 482 to be the correct price.'[94] In this instance, the applicable penalty increases to 40% of the underpayment of tax.

Example
A US Company (US Co.) manufactures widgets and sells them to affiliates around the world. US Co.'s cost to produce each widget is USD 6. US Co. sells each widget to its Italian distributor (Ital Co.) for USD 10 per widget. US Co. sells 25,000 widgets to Ital Co.

Profit: USD 10 – USD 6 = USD 4 per widget
Total Profit: 25,000 × USD 4 =USD 100,000

Under audit, the IRS determines that the proper transfer price should have been USD 21 per widget. Given this adjustment, the taxpayers income increases as follows:

Profit: USD 21 – USD 6 = USD 15 per widget
Total Profit: 25,000 × USD 15 = USD 375,000

IRS Adjustment to Profit: USD 375,000 – USD 100,000 = USD 275,000

A 20% transactional penalty applies because the price per widget reported (USD 10) is 50% or less of the adjusted price per widget as determined by the Service (USD 21).

Under the transactional penalty regime, it should be noted that if the taxpayer fails to impose a transfer price where one is justified, then by definition, a gross valuation transactional penalty would be triggered. For example, suppose an intercompany service transaction is not properly identified and thus no payment is made. Under audit, the Service identifies the transaction and prices the transaction at some amount greater than zero. Since any positive

93. Treasury Regulation §1.6662-6(b)(1).
94. Treasury Regulation §1.6662-6(b)(2).

amount is infinitely greater than zero in percentage terms, the gross valuation transactional penalty would apply.

3.2.3. The Net Adjustment Penalty

In addition to the penalty thresholds set forth in the transactional penalty, penalties can also be triggered by the aggregate of all allocations made under section 482. This type of penalty is called the net adjustment penalty:

> The term net section 482 adjustment means the sum of all increases in the taxable income of a taxpayer for a taxable year resulting from allocations under section 482 (determined without regard to any amount carried to such taxable year from another taxable year) less any decreases in taxable income attributable to collateral adjustments as described in Treasury Regulation §1.482- 1(g).[95]

Similar to the transactional penalty, the regulations put forth 'substantial' and 'gross' misstatement thresholds for the net adjustment penalty. The thresholds related to substantial and gross valuation misstatements and the resulting penalties are further described below.

3.2.3.1. Substantial Valuation Misstatement

Unlike the transactional penalty which is triggered when the size of misstatement reaches certain thresholds on a relative basis, the net adjustment penalty is triggered when a single or aggregation of misstatements reach a certain absolute size. 'There is a substantial valuation misstatement if a net section 482 adjustment is greater than the lesser of 5 million dollars or 10% of gross receipts.'[96] Under the net adjustment penalty framework, if there is a substantial valuation misstatement, the applicable penalty is 20% of the underpayment of tax.

3.2.3.2. Gross Valuation Misstatement

Similar to the transactional penalty, the more severe net adjustment penalty occurs when there is a gross valuation misstatement. 'There is a gross valuation misstatement if a net section 482 adjustment is greater than the lesser of 20 million dollars or 20% of gross receipts.'[97] In this instance, the applicable penalty increases to 40% of the underpayment of tax.

95. Treasury Regulation §1.6662-6(c)(1).
96. Treasury Regulation §1.6662-6(c)(2).
97. Treasury Regulation §1.6662-6(c)(3).

Example

A US Company (US Co.) manufactures widgets and sells them to affiliates around the world. US Co.'s cost of production is USD 6 per widget. US Co. sells each widget to its Italian distributor (Ital Co.) for USD 10 per widget. US Co. sells 700,000 widgets to Ital Co. Gross receipts of US Co. are USD 70 million.

Profit: USD 10 – USD 6 = USD 4 per widget
Net Income: 700,000 × USD 4 =USD 2,800,000

Under audit, the IRS determines that the proper transfer price should have been USD 18 per widget.

Profit: USD 18 – USD 6 = USD 12 per widget
Net income: 700,000 × USD 12 = USD 8,400,000

IRS adjustment to net income: USD 8,400,000 – USD 2,800,000 = USD 5,600,000

The Service's price adjustment increases US Co.'s net income by USD 5.6 million. The net adjustment pursuant to section 482 is greater than the lesser of USD 5 million and USD 7 million (10% of gross receipts); therefore a 20% penalty is added to the additional tax due.

3.2.4. Coordination of Penalties

Theoretically, certain adjustments can lead to both a transactional penalty and a net adjustment penalty. However, under Treasury Regulation §6662-6(f), the IRS cannot impose multiple penalties on the same adjustment. Treasury Regulation §6662(f) provides for the coordination of penalties. The required coordination is detailed below.

3.2.4.1. Coordination of a Net Section 482 Adjustment Subject to the Net Adjustment Penalty and a Gross Valuation Misstatement Subject to the Transactional Penalty

If a gross valuation transactional penalty is triggered on a proposed adjustment (because the reported price is equal to or less than 25% of the adjusted price) and a substantial valuation net adjustment penalty is also triggered because the adjusted price exceeds 5 million dollars (but is less than 20 million dollars), the Service is required to coordinate between a gross valuation transactional penalty and a substantial valuation net adjustment penalty. In this instance, any amount of the adjustment that is related to the gross valuation misstatement

triggering the transactional penalty is subject to a 40% penalty. The remaining portion of the adjustment is subject to a 20% penalty.

Example

A US Company (US Co) manufactures widgets and sells them to affiliates around the world. US Co's cost of production is USD 6 per widget. US Co sells each widget to its Italian distributor (Ital Co) for USD 10 per widget. US Co sells 200,000 widgets to Ital Co.

Profit: USD 10 – USD 6 = USD 4 per widget
Net income: 200,000 × USD 4 =USD 800,000

Under audit, the IRS determines that the proper transfer price should have been USD 41 per widget.

Profit: USD 41 – USD 6 = USD 35 per widget
Net income: 200,000 × USD 35 = USD 7,000,000

IRS adjustment to net income: USD 7,000,000 – USD 800,000 = USD 6,200,000

The Service's price adjustment increases US Co's net income by USD 6.2 million. Since the net adjustment is greater than USD 5 million a 20% net adjustment penalty theoretically applies. In addition, since the reported price is 25% or less of the adjusted price reported price; a 40% transactional penalty also theoretically applies.

In this example, two penalties are theoretically triggered. Since the coordination of penalties protects the taxpayer from the application of both penalties, the penalty would be applied as follows:

- The portion of the adjustment that triggers the gross valuation transactional penalty is subject to a 40% penalty. Therefore the income triggering the 40% penalty equals USD 1 × 200,000 = USD 200,000.
- The remaining portion of the adjustment is subject to the 20% penalty. Thus the income subject to the 20% penalty is (USD 40 – USD 10) × 200,000 = USD 6,000,000.

3.2.4.2. Coordination of a Net Section 482 Adjustment Subject to the Net Adjustment Penalty and Substantial Valuation Misstatement Subject to the Transactional Penalty

When an adjustment theoretically triggers a substantial transactional penalty and a gross misstatement net adjustment penalty (where the net section 482

adjustment exceeds 20 million dollars or 20% of gross receipts), the entire amount of the adjustment would be subject to the net adjustment penalty at 40%. Under the coordination of penalties rules, no portion of the adjustment would be subject to the penalty at a 20% rate.

3.2.5. Reasonable Cause and Good Faith

In general, the Reasonable Cause and Good Faith section of the regulations states that no penalty shall be imposed with respect to any portion of an underpayment, if the taxpayer acted in good faith and had reasonable cause to believe that its transfer pricing met the requirements set forth in Section 482.

'A taxpayer that meets the requirements of paragraph (d) of this section with respect to an allocation under 482 will be treated as having established that there was reasonable cause and good faith'[98] The taxpayer must also meet certain contemporaneous documentation requirements to demonstrate reasonable cause and good faith efforts under 1.6662.

3.2.6. Specified and Unspecified Method Requirements

The taxpayer can meet the selected method requirements by applying a method that was determined to be the 'best method' as discussed in section 1.4.1, as long as this determination was made in a reasonable manner. For the best method selection to be considered reasonable, all of the relevant facts and circumstances must be considered.

'Determinative factors include:

- Experience and knowledge of taxpayer;
- Availability of reliable data and reasonability of data analysis;
- The extent to which the taxpayer's application of the selected method meets the requirement of section 482;
- Extent to which the taxpayer reasonably relied on a study or other analysis performed by a professional that is qualified to perform such analysis;[99]
- The taxpayer's arm's-length result falls within a range of results when more than one uncontrolled comparable is used;
- Whether or not the selected method of analysis was approved in a prior year under audit or by the Advanced Pricing Agreement Program and

98. Treasury Regulation §1.6662-6(b)(3).
99. 'A study or analysis that was reasonably relied upon in a prior year may reasonably be relied upon in the current year if the relevant facts and circumstances have not changed or if the study or analysis has been appropriately modified to reflect any change in facts and circumstances.' Treasury Regulation §1.6662-6(d)(2)(ii)(D).

to what extent the taxpayer's facts and circumstances have changed from that prior year; and
– Size of adjustment in relation to the size of the original controlled transaction.'[100]

3.2.7. Carrybacks and Carryovers

If it is determined that an adjustment is necessary, and such adjustment gives rise to a substantial or gross valuation misstatement for a taxable year in which the taxpayer incurred a taxable loss, the resulting penalty will be imposed on any resulting underpayment of tax in the taxable year in which the losses created by the misstatement were utilized.

To determine the resulting substantial or gross valuation misstatement for a taxable year, the amount applied from another taxable year will not be used to determine the application of the penalty. The following example illustrates the principle.

Example
Company A reported a loss of five million dollars on their income tax return in year one and then received a section 482 adjustment of six million dollars for the year one tax year. The originally stated loss of five million dollars had been carried forward to the income tax return in year two and used to reduce income taxes otherwise due in year two.

In year one, the six million dollar adjustment constitutes a substantial valuation misstatement and thus triggers the applicable penalty of 20% of the additional taxes owed in year one. Therefore, in year one, the 20% penalty is applied to the tax owed on USD 1 million of taxable income. In addition, since there was taxable income in year one (post adjustment), the net operating losses that were carried forward to year two are no longer valid. This creates an under reporting of income in year two of the remaining USD 5 million. The underpayment of tax associated with this additional income in year two is also subject to the 20% penalty that was triggered in year one since that is when the misstatement occurred. This amount will not be included in evaluating whether or not any misstatements made in year two are also subject to a penalty.

3.3. Sufficiency of Documentation Reports for Purposes of Avoiding Penalties

Treasury Regulation §1.6662-6(d) states that an adjustment can be excluded from the calculation of a net section 482 adjustment penalty if the taxpayer

100. Treasury Regulation §6662-6(d)(2)(ii).

can demonstrate that both the best method and contemporaneous documentation requirements are met with respect to the transaction or set of transactions relevant to the adjustment. It should be noted that the existence of documentation alone is not sufficient to avoid penalties under the good faith and reasonable cause exception. To be protected from penalties, the taxpayer must have prepared such documentation contemporaneous with the timely filing of its US tax return so that the return is reflective of such analysis.

Also worthy of note is that a taxpayer is not subject to a penalty for not having contemporaneous transfer pricing documentation; its existence is not mandatory. Only adjustments can trigger transfer pricing related penalties.

4. SPECIAL CONSIDERATIONS IN US TRANSFER PRICING

4.1. FIN 48 Consideration

The Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes in June 2006. FIN 48 requirements apply to an enterprise's tax-related risks, including transfer pricing positions. FIN 48 became effective for fiscal years beginning after 15 December 2006 for all US public companies, and it became effective 15 December 2008 for all US private and tax exempt entities that prepare GAAP financial statements. FIN 48 was drafted to help clarify the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109 (SFAS 109), Accounting for Income Taxes. FIN 48 replaces SFAS No. 5, Accounting for Contingencies, with respect to the accounting for all tax positions, not just uncertain tax positions.

A recent effort to recodify the various accounting pronouncements has resulted in FIN 48 being renamed to ASC 740. Despite this codification change, most taxpayers and practitioners still refer to this section as FIN 48, as is done in this chapter.

4.1.1. Justification for Issuing FIN 48

The FASB states in its FIN 48 pronouncement that, 'in principle, the validity of a tax position is a matter of tax law. It is not controversial to recognize the benefit of a tax position in an enterprise's financial statements when the degree of confidence is high that that tax position will be sustained upon examination by a taxing authority'.[101] The challenge faced by taxpayers,

101. FASB Interpretation No. 48, Summary, June 2006.

outside advisors and auditors arises when varied interpretations of a specific tax provision or tax reporting position exist. Tax law, not unlike other areas of the law, is subject to varied opinions and interpretations by taxpayers, courts and tax administrators.

SFAS No. 109, Accounting for Income Taxes, contains no clear guidance on how a taxpayer should address uncertainty in accounting for income tax assets and liabilities. 'As a result, diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in non-comparability in reporting income tax assets and liability.'[102]

FIN 48 is intended to provide consistency in how enterprises identify and account for tax positions on financial statements. FASB believes, 'this Interpretation [FIN 48] will result in increased relevance and comparability in financial reporting of income taxes because all tax positions accounted for in accordance with FAS 109 will be evaluated for recognition, derecognition, and measurement using consistent criteria'.[103]

4.1.2. FIN 48 Scope

FIN 48 applies to all tax positions that fall within the scope of FAS 109. FASB considers the term 'tax positions' to include the following:

(1) A decision not to file a tax return.
(2) An allocation or a shift of income between jurisdictions.
(3) The characterization of income or a decision to exclude reporting taxable income in a tax return.
(4) A decision to classify a transaction, entity, or other position in a tax return as tax exempt.[104]

Item (2) above clearly relates to transfer pricing, as the execution of a transaction across jurisdiction borders necessarily allocates income between those jurisdictions.

FIN 48 guidelines apply to tax positions that are considered 'routine' as well as those positions with a higher degree of uncertainty. Furthermore, no materiality considerations are specifically stated in FIN 48. Instead, materiality is a facts-and-circumstances issue that the taxpayer and its outside auditor should address and agree upon during each disclosure period. FASB Interpretation No. 48 states,

102. FASB Interpretation No. 48, Summary, June 2006.
103. FASB Interpretation No. 48, Summary, June 2006.
104. FASB Interpretation No. 48, para. 4, June 2006.

> The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence.[105]

FASB goes on to state that the taxpayer, when assessing its tax positions, 'shall consider the manner in which the enterprise prepares and supports its income tax return'.[106] FASB also expects the taxpayer and its auditor to consider the position the taxing authority in the various jurisdictions will apply when reviewing the tax returns.

4.1.3. FIN 48 Implementation Guidelines

When implementing FIN 48, companies need to determine and assess all positions taken in any income tax return as of the date the company adopts FIN 48. This includes all uncertain positions in all tax years that remain subject to assessment or challenge by a taxing jurisdiction. Each position is then subjected to two distinct evaluations: Recognition and Measurement. Paragraph 6 of FASB Interpretation No. 48 describes Recognition and states that, 'an enterprise shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination'.[107]

FASB defines the term, more likely than not (MLTN), to mean, '... a likelihood of more than 50%'[108] that a taxpayer's position would be sustained if challenged and considered by the highest court in the relevant taxing jurisdiction. The MLTN threshold is a positive assertion on the part of the taxpayer that based on its analysis of the relevant facts and circumstances it is entitled to economic benefits associated with a specific tax position. FASB states that when performing a MLTN analysis, the enterprise should consider the following three items:

(1) It shall be presumed that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.
(2) Technical merits of a tax position derive from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and

105. FASB Interpretation No. 48, para. 5, June 2006.
106. FASB Interpretation No. 48, para. 5, June 2006.
107. FASB Interpretation No. 48, para. 6, June 2006.
108. FASB Interpretation No. 48, para. 6, June 2006.

circumstances of the tax position. When the past administrative practices and precedents of the taxing authority in its dealings with the enterprise or similar enterprises are widely understood, those practices and precedents shall be taken into account.

(3) Each tax position must be evaluated without consideration of the possibility of offset or aggregation with other positions.[109]

The Measurement step of FIN 48's two-step process requires that the amount of tax benefit for a qualifying tax position be recognized as the largest amount of tax benefit that is more than 50% likely to be sustained upon effective settlement with a taxing authority that has full knowledge of all the relevant information. The following table helps to illustrate this concept. Assume a tax position has the following distribution pattern of possible realized upon benefit outcomes:

Possible Estimated Outcome	*Individual Probability of Occurring (%)*	*Cumulative Probability of Occurring (%)*
USD 100 (Complete success in litigation or settlement with the IRS)	10	10
USD 80 (Very favourable compromise)	20	30
USD 60 (Fair compromise)	*25*	*55*
USD 40 (Unfavourable compromise)	30	85
USD 0 (Total loss)	15	100

In this example, USD 60 is the amount of tax benefit that would be recognized in the financial statements, because it represents the largest cumulative amount (i.e., 30% + 25% = 55%) of benefit that is more than 50% likely to reflect the ultimate outcome. It is hoped that one expected outcome will be clearly more probable than other possible outcomes; however, in those cases

109. FASB Interpretation No. 48, para. 7, June 2006.

where the outcome isn't as obvious, substantial analysis will be required before a taxpayer can arrive at the appropriate benefit to recognize on the financial statements.

Unresolved uncertain tax positions must be reassessed each time the enterprise formally issues GAAP financials to outside investors. When making its regular assessments, management should determine whether or not any of the factors underlying the sustainability assertion have changed, as well as whether or not the amount of recognized tax benefit is still appropriate. Factors that would influence management's assessment include:

- new court rulings;
- changes in the law;
- new regulations;
- guidance or rulings from tax authorities; and
- interactions with auditors and tax administrators.

FIN 48 does not permit a taxpayer to make a different assessment of the same information that was used to reach the initial opinion. A different assessment must be supported by subsequent developments. FASB writes, 'Subsequent changes in judgment that lead to changes in recognition, derecognition, and measurement should result from the evaluation of new information and not from a new evaluation or new interpretation by management of information that was available in a previous financial reporting period.'[110]

Finally, a taxpayer is required to accrue interest and penalties that, under relevant tax law in the respective jurisdictions, the taxpayer would incur if the uncertain tax position ultimately was not sustained. If the law requires a taxpayer to remit interest for an underpayment of taxes, then the taxpayer should, 'begin recognizing interest expense in the first period the interest would begin accruing according to the provisions of the relevant tax law'.[111] The same is true for penalties that could be assessed for an underpayment of taxes. FASB states, 'An enterprise shall recognize an expense for the amount of the statutory penalty in the period in which the enterprise claims or expects to claim the position in the tax return.'[112]

4.1.4. FIN 48 Disclosures

One of the biggest changes, as well as most controversial aspects, between FIN 48 and SFAS 5 are the disclosure requirements. Previously, a taxpayer could 'bundle' together of its uncertain tax positions and provide a general

110. FASB Interpretation No. 48, para. 12, June 2006.
111. FASB Interpretation No. 48, para. 15, June 2006.
112. FASB Interpretation No. 48, para. 16, June 2006.

cushion or reserve against the possibility of not being able to claim some of the tax positions reflected on its returns for various taxing jurisdictions.

The disclosure provisions found in FIN 48 require enterprises to prepare and report a much more detailed analysis of their various tax positions. These new disclosure guidelines require a taxpayer to annually provide, in tabular form on a worldwide aggregated basis, a reconciliation of the total amount of unrecognized tax benefits at the beginning of the period to the total amount of unrecognized tax benefits at the end of the period. The specific disclosures include:

- The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.
- The total amounts of interest and penalties that are recognized in the statement of operations as well as in the statement of financial position.
- For tax filing positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within twelve months of the reporting date:
  (a) The nature of the uncertainty.
  (b) The nature of the event that could occur in the next twelve months that would cause the change.
  (c) An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made.
- A description of the open tax years by major jurisdiction.[113]

4.1.5. FIN 48 and Transfer Pricing

FIN 48 requirements apply to an enterprise's transfer pricing positions. Like other tax-related risks, a taxpayer must evaluate and disclose all transfer pricing-related risks, and the availability of the appropriate transfer pricing documentation is only one of several risk factors that a taxpayer should consider when reviewing its transfer pricing positions. Other items that should be considered include the selected transfer pricing methodology, the reported comparables, entity classification, audit history, formal negotiations (e.g., competent authority, Advanced Pricing Agreements, etc.) between the taxpayer and taxing authorities, and any other items that might impact the likelihood that a particular transfer price would not be sustained upon audit by the relevant taxing authority(ies).

When identifying the Unit of Account for a FIN 48 analysis of transfer pricing positions, the taxpayer detailed may find it helpful to organize data at a granular level by separating, for example, annual amounts of income or expenses charged for specific transaction types between pairs of jurisdictions.

113. FASB Interpretation No. 48, para. 21, June 2006.

A best practice when performing these analyses is to first look at either the income or expense level detail of the intercompany transactions. The various tax impacts from these revenue streams or expenses can be examined later in the risk assessment process. This practice is largely influenced by the fact that IRS Form 5471 and its foreign equivalents report income and expense by legal entity. The associated analyses and documentation of transfer pricing between jurisdictions to determine arm's-length pricing are generally presented at this same level.

Determining whether or not a transfer pricing position is MLTN to be upheld when applying the Recognition step of FIN 48 should involve asking the following question, 'Is it More Likely Than Not that revenue can be recognized or expenses can be deducted for a given sale/purchase of goods, services or intangibles between two related parties?' Experience has shown that most intercompany transactions will pass the MLTN test for recognition of income or deduction of expense. The question of 'What amount will be sustained under audit for these intercompany transactions?' is generally treated under the Measurement step of FIN 48.

Completing a cumulative probability test for transfer pricing positions is similar to what the taxpayer would do when evaluating other tax matters. The enterprise should identify and measure the various pricing alternatives that a taxing authority might apply when challenging the company's its intercompany transfer pricing for a specific transaction. These transfer pricing scenarios might consider the use of different comparables. Another scenario could include changing the characterization of the intercompany transaction. For example, imbedding a royalty payment in the tangible product price rather than splitting the payment into two separate transactions could be used as an alternative scenario. Applying a different transfer pricing methodology to calculate the intercompany charge is another alternative that could be considered in the scenario analysis.

4.1.6. Implementing FIN 48 for Transfer Pricing

When implementing FIN 48 for transfer pricing a taxpayer needs to perform discrete activities or steps that will lead to an appropriate disclosure of risk. The following four steps summarize the key activities that a taxpayer should perform.

4.1.6.1. Step 1: Identify Unit of Accounts

The taxpayer should engage in discussions with its auditors early in the process. These discussions should focus on materiality thresholds, open tax periods that will be evaluated, how information will be gathered, who will

conduct the analysis, and how work papers will be prepared and retained. The goal is to have consistent policies and procedures to ensure that the analysis is complete and repeatable in future reporting periods.

Preparing a template for capturing relevant information is a best practice that is employed by many taxpayers. Helpful information to include along with each Unit of Account includes:

- Unit of Account identifier.
- Transaction type.
- Relevant fiscal year end.
- Transaction amount (put this information into a single currency, usually US dollars).
- Entity receiving service (i.e., payer).
- Entity performing service (i.e., payee).
- Entity's legal jurisdiction.
- Open/closed audit periods.

Information sources include tax returns, transfer pricing reports, management reporting systems as well as intercompany agreements and invoices. If the taxpayer has entered into Advance Pricing Agreements (APAs) or has engaged in competent authority proceedings, this information should also be collected and analysed.

4.1.6.2. Step 2: Preliminary Analysis

In some cases a taxpayer may be able to exclude certain Units of Account from its analysis if the auditors agree that these Units of Account should have no material impact on the FIN 48 reserve calculations. For example, the following items might be considered for exclusion from the FIN 48 evaluation:

- Transactions that fall under the materiality thresholds.
- Transactions for which the audit years are closed for both related parties.
- Transactions that are already covered on all relevant sides by an APA.
- Transactions that occur within the same taxing jurisdiction (consider state, local and provincial jurisdictions as well).

It should be noted that FIN 48 requires evaluation of all tax positions as defined under FAS 109 and does not provide for these types of exclusions. This step is one of a purely practical nature and may not be applicable to many taxpayers. For those Units of Account that are excluded, the taxpayer's work-papers should have clear documentation of the reason(s) why they are no longer being evaluated. Also, the taxpayer should share this information with its auditors as soon as possible to ensure that excluded Units of Account are indeed no longer required to be evaluated.

4.1.6.3. Step 3: Detailed Review

For those Units of Account that failed to pass the Step Two preliminary analysis, a more detailed review of the facts and circumstances must be completed. Specifically, the taxpayer should develop various key scenarios that might result if the Unit of Account is subject to audit by a tax authority. For each of these scenarios, the taxpayer should assign a probability of the outcome actually coming to pass. As is done in Step Two, the taxpayer should document the analysis and rationale behind each scenario and the associated probabilities.

Greatest effort should be focused on documenting why those scenarios with a cumulative probability of greater than 50% are the ones that should be used in the reserve calculation. Those Units of Account that do not require a reserve should also be tracked and monitored in future reporting periods.

4.1.6.4. Step 4: Implementation

Upon completing steps one through three, the taxpayer should review the preliminary results with the auditors and confirm the assumptions used in the probability analysis. The FIN 48 report that is prepared and issued to the relevant stakeholders (e.g., CFO, Board of Directors and auditor) should contain the following information.

- An overview of the taxpayer's business.
- A complete listing of all intercompany transactions that were identified and examined.
- A discussion of the materiality and time period considerations that were addressed during the FIN 48 review.
- A description of the recognition and measurement process that was employed for the analysis.
- A summary of the FIN 48 liability and disclosure amounts.

FIN 48 workpapers are an important output from the process, and have gathered a lot of attention. FIN 48 workpapers should contain the following information.

- Unit of Account matrices.
- Detailed measurement worksheets.
- Alternative scenario calculations.
- FIN 48 reserve calculations.
- FIN 48 report.
- Internal FIN 48 process memoranda.

The IRS has a formal policy dating back to the 1980s of not requesting taxpayer workpapers. However, the trend appears to be changing, as the

IRS is now asking for workpapers in taxpayer audits.[114] Because of the information that is contained in the workpapers, it is critical that the taxpayer obtain legal advice on how to properly classify documents as either privileged or confidential. It is also important that the taxpayer develop internal communication protocols to help properly track what is being documented and retained, and to ensure that the appropriate labelling (e.g., confidential or privileged) is included on all workpapers.

4.1.7. Schedule and Instructions for Uncertain Tax Positions

In early 2010, the IRS announced its intent to require taxpayers to disclose all uncertain tax positions on their tax returns. The Service crystallized the requirement through Announcement 2010–2030 ('the announcement') which introduced a draft Schedule and Instructions for Uncertain Tax Positions (Schedule UTP) to be completed by the taxpayer.

Generally, tax payers must disclose the maximum possible IRS tax adjustment by unit of account. However, for transfer pricing tax positions, taxpayers must rank items (see below) rather than disclosing maximum amount. In addition to the ranking by unit of account transactions the proposed Schedule UTP requires ranking of uncertain positions by:

(1) the amount recorded as a reserve for U.S. federal income tax for that position taken on the tax return; or
(2) the estimated adjustment to U.S. federal income tax that would result if the tax position taken on the tax return is not sustained.

The ranking requirements of the proposed Schedule UTP take a one-sided view (U.S. only). Therefore, the taxpayer may need to develop different presentation for the Schedule UTP than financial statement reserve calculations, which likely consider multiple tax authorities' perspectives and generally allow for tax offsets in the calculations between treaty countries.

At the time of this publication, the IRS is soliciting feedback regarding the proposed Schedule UTP and plans to issue a final schedule in the subsequent months.

4.2. Global Dealing

4.2.1. Introduction

On 6 March 1998, the IRS issued proposed regulations to provide guidance on applying the arm's-length principle to transactions between controlled

114. BNA 17 Transfer Pricing Report 354, 9/11/08.

taxpayers engaged in global dealing operations (the Proposed Regulations).[115,116] A global dealing operation is generally defined as the execution of customer transactions in securities, derivatives, and other financial products in multiple tax jurisdictions by a regular dealer in securities (i.e., purchases securities from/sells securities to unrelated parties). Transfer pricing issues arise in global dealing since relevant activities, including marketing, sales, pricing, risk management and trading, may be performed by related parties (e.g., commonly controlled entities or branches) located in different tax jurisdictions.

The definition of a global dealing operation does not require that the dealer activity be performed on either a global or continuous basis (i.e., it is not restricted to only circumstances in which a book is passed from trader to trader in multiple locations to insure continuous coverage). Moreover, global dealing does not include proprietary trading (unless the positions are entered into by a regular dealer in connection with customer-driven trades), lending activities, credit analysis, accounting and other back-office services, or the provision of a guarantee of one or more transactions assumed by a regular dealer or participant.

Global dealing operations present a number of challenges to traditional tax and transfer pricing principles. Chief among these are: (i) issues surrounding whether global dealing and related activities create a permanent establishment (PE) and, if so, how to determine the income attributable to the PE; (ii) the role of capital; and (iii) whether ancillary transactions, such as the provision of guarantees, affect the risks assumed by global dealing participants, and how these transactions should be priced. These challenges illustrate some of the complexities surrounding global dealing operations, and perhaps help to explain why the Proposed Regulations have yet to be re-proposed as oft-promised in recent years.[117]

4.2.2. Permanent Establishment

As a threshold matter, the Proposed Regulations do not explicitly address whether a branch constitutes a PE (or 'qualified business unit' per the Proposed Regulations), or in what circumstances a PE would be created. Transfer pricing guidance issued by the OECD in the 'Report on the Attribution of Profits to Permanent Establishments', adopted in final form on 17 July 2008

115. Proposed Regulations §1.482-8, 63 Fed. Reg. 11177, 'Allocation and Sourcing of Income and Deductions Among Taxpayers Engaged in a Global Dealing Operation.'
116. While proposed regulations do not carry the force of law, they represent the US Department of Treasury's latest guidance and may be relied upon by taxpayers in analysing relevant tax matters.
117. Most recently, the 2009–2010 Priority Guidance Plan issued by the US Department of Treasury on 24 Nov. 2009 lists guidance on global dealing under §1.482 as a priority.

(OECD Report on PEs), does not address this threshold question either. Thus a common concern among taxpayers engaged in global dealing operations is whether or not activities may create a PE and therefore give rise to potential tax liability. For example, would a trader in Singapore covering the book of the US ParentCo on a limited basis create a taxable presence for the United States in Singapore? In other words, could Singapore tax any of US ParnetCo's income? While Article 5 of the OECD Model Treaty (Permanent Establishment) may provide general guidance, the determination of whether or not a PE is created by global dealing activity requires an analysis of the specific tax treaty and related protocols between the countries in question.

When an activity is deemed to create a PE, a second concern among taxpayers is how much income to attribute to the PE. Principles related to the attribution of profits to a PE often rely on sourcing rules, which may not adequately address the complexity of global dealing operations. Traditional sourcing notions are based on the location of the functions that generate the income, but in global dealing operations, various value-add functions that support the trading activity are often performed in multiple locations. For example, an office in Country X may price and sell a financial product that is booked in Country Y. How much income generated by the trade should be sourced in X, and how much is sourced in Y? Sourcing determination may be further complicated by local tax rules, particularly if the activity is conducted through a branch and is taxed on an 'all-or-nothing' basis. In such situations, all of the gross income and expenses from the transaction is included in the calculation of taxable income if sufficient activities are performed in that jurisdiction. Otherwise, none of the income or expense may be attributed to the branch absent the requisite level of activity. In the hypothetical example, if the activity of the branch office in Country X does not meet the sufficiency test, then none of the income would be sourced to Country X. This seemingly creates an inconsistency with the arm's-length standard, as X should receive some compensation for the functions performed in generating the income sourced to Y.

The OECD attempts to address this concern by adopting a 'functionally separate entity' approach in the OECD Report on PEs. Under this approach, the profits attributed to a PE are the profits it would have earned if it were a legally distinct and separate enterprise performing comparable functions. The Proposed Regulations under §1.482-8 do not specifically address the attribution of income to a branch or PE, but include revisions to the sourcing rules under §1.863 which provide that the source of income generated by a global dealing operation is determined by applying transfer pricing principles and allocating the applicable income as if each qualified business unit (i.e., PE) that performs related dealer activities were a separate controlled taxpayer. This appears similar in principle to the OECD authorized approach. However,

there may be a fair amount of subjectivity in determining the functions performed and risks assumed by the hypothesized separate entity, which may give rise to potential controversy. Given taxpayer concern over issues surrounding PEs, and the adoption of the OECD Report on PEs, it remains to be seen whether the IRS will explicitly address such matters in re-proposed regulations on global dealing operations, or otherwise maintain consistency with OECD guidance.

4.2.3. The Role of Capital

In global dealing operations, sufficient capital is required to support the risks assumed (e.g., unexpected losses), and to satisfy regulatory requirements. It is well understood by taxpayers and tax authorities alike that the provider of capital in global dealing activities is entitled to compensation. What is debatable to many taxpayers, however, is what role capital assumes in global trading operations. The Proposed Regulations contend that the provision of capital is a routine function, and that sufficient comparable data exists to establish a market-based return to the capital pledged. Many taxpayers and practitioners believe that the capital provider assumes the risks associated with unanticipated economic losses. As such, the capital provider performs a non-routine function, and is therefore entitled to a share of the residual profit. In practice, many taxpayers argue the applicability of the 'hedge fund model' to global trading operations. Under this model, capital providers (viewed as comparable to investors in a hedge fund) typically receive 80% of the profit remaining once operating expenses and routine returns are provided, with the remaining 20% inuring to the trading function (comparable to hedge fund managers).

The OECD Report on PEs on the whole sides with the position taken in the Proposed Regulations that the provision of capital is routine. Tax authorities are concerned that imparting a non-routine or potentially high value to the provision of capital may result in the movement of capital to lower-tax jurisdictions. However, the OECD appears to allow more flexibility on this point, as the OECD Report on PEs concedes that the hedge fund model may provide a reasonably reliable comparable in certain circumstances, such as quasi-proprietary trading. Previous versions of the OECD Report on PEs had entirely rejected the hedge fund approach. This softening perhaps reflects industry dynamics that have emerged in the years following issuance of the Proposed Regulations.

Regardless of whether the provision of capital is viewed as routine or non-routine, neither the Proposed Regulations nor the OECD Report on PEs provides explicit guidance on methods to determine arm's-length compensation for the provision of capital. Consequently, the compensation of capital remains a concern to taxpayers. How the IRS will address the issues

surrounding the role and compensation of capital may be a contributory factor in the delay of the issuance of re-proposed regulations.

4.2.4. Guarantees

Another challenge presented by global dealing transactions is whether the provision of guarantees affects the risks assumed by global dealing participants, and how these transactions should be priced. To the extent that the capital provider in a global trading organization, for example, funds the capital to support a particular transaction or the activity as a whole by borrowing from third parties, a financial guarantee from an affiliate (usually the parent company) may be required to obtain the financing, or to do so at reasonable interest rates. A financial guarantee effectively allows the recipient to 'borrow' the credit rating of the provider, and shifts some of the risk to the guarantor. An operational guarantee may also be extended in a global trading organization, whereby an affiliate agrees to assume the activity and/or associated liability in the event of performance default by the related service provider. The provider of the guarantee should be compensated for putting some portion of its balance sheet at risk.

There is little guidance on how the extension of guarantees should be compensated. The Proposed Regulations do not address the provision of a guarantee, and the US transfer pricing rules for services transactions (finalized 31 July 2009) explicitly exclude guarantees as a covered service for application of the SCM[118] (potentially allowing taxpayers to argue for zero compensation for guarantees since they do not incur explicit costs). Further, the US services rules do not opine on whether the provision of a guarantee constitutes a service or otherwise provide guidance on methods that may be used to price a guarantee (while indicating that such guidance might be forthcoming when the global dealing regulations are re-issued). The recent high-profile General Electric Canada case whereby the Tax Court of Canada vacated an assessment by the Canada Revenue of Canada resulting from a previous denial of deductions for payment of guarantee fees by General Electric Capital Canada Inc. to its related party in the United States, General Electric Capital Corporation, highlights some of the tensions between taxpayers and tax authorities related to support (implicit or explicit) of an affiliate and the associated pricing. It remains to be seen how regulatory guidance may be influenced by the GE Canada decision, but the IRS may well be considering guarantees, both generally and with respect to the potential impact on global dealing operations, before issuing re-proposed regulations.

118. Treasury Regulation §1.482-9T(b)(3)(ii).

4.3. APA Program

The APA Program provides a voluntary process for taxpayers who want to resolve actual or potential transfer pricing-related disputes outside the traditional audit process. The process is built on the principles of cooperation and open communication between the taxpayer and the Internal Revenue Service (IRS or the Service). From the IRS's perspective, the APA process:

> lessens the burden of compliance by giving taxpayers greater certainty regarding their transfer pricing methods, and promotes the principled resolution of these issues by allowing for their discussion and resolution in advance before the consequences of such resolution are fully known to taxpayers and the [Internal Revenue] Service.[119]

An APA, once agreed to and signed by both the taxpayer and the IRS, is a binding contract. Under this APA contract, both the IRS and the taxpayer agree to do certain things. The IRS agrees not to seek a transfer pricing adjustment under Treasury Regulation §1.482 for the covered transaction(s), and the taxpayer agrees to file timely tax returns and Annual Reports for the covered years consistent with the agreed upon TPM articulated in the APA agreement.

4.3.1. APA Program Background

The IRS launched the APA Program in 1991 with the issuance of Rev. Proc. 91-22.[120] Since that time, the process has evolved through a series of changes, including a substantial update of the procedural rules for processing and administering an APA in December, 2005.[121] In addition to the procedural changes in 2005, the IRS created five teams within the APA Office to focus on industry specific issues. The five focus areas are: automotive and auto parts; pharmaceuticals and medical devices; financial products; semiconductors; and cost sharing. These five groups were selected because, historically, the APA case load in these five categories has accounted for roughly 40% of the APA Program's case load, and about half of its total case time.[122] The IRS hopes that by creating these teams of specialized resources, it can increase its efficiency, quality and consistency in processing APAs that fall into one of the five categories.

The most recent changes to the APA Program occurred in 2008 when the Service added additional language to Rev. Proc. 2006–2009 that advised

119. IRS Rev. Proc. 2006-09, 2006-1, C.B. 278.
120. IRS Rev. Proc. 91-22, 1991-1, C.B. 526.
121. IRS Rev. Proc. 2006-09, 2006-1, C.B. 278.
122. Announcement and Report Concerning Advance Pricing Agreements, IRS, 27 Mar. 2009.

taxpayers that the APA process could be used to resolve any issue where transfer pricing principles may be relevant (e.g., the attribution of profit to a permanent establishment, income connected with the conduct of a US trade or business). The IRS continues to work on initiatives to improve the APA process, including efforts to 'fast-track' APA filings, as well as enhanced processes for small business taxpayers who are seeking an APA.

Since its inception in 1991, the APA program has received 1,252 APA applications through 31 December 2008.[123] During this same time period, the IRS has executed 841 APA agreements (this includes APA renewals, but not APAs revised or amended).[124] The most recent IRS data also shows that the average amount of time to complete a new APA is 18.7 months, and it takes an average of 18.4 months to renew an existing APA agreement.[125] During 2008, the following five transaction types accounted for more than 75% of the 123 applications filed during that year:[126]

- Sale of tangible property into the United States.
- Performance of services by a US entity.
- Performance of services by Non- US entity.
- Use of intangible property by Non- US entity.
- Use of intangible property by US entity.

4.3.2. APA Process

The APA process is initiated by the taxpayer and not the IRS. Participation in the process is entirely voluntary and is not mandated. However, there are cases where the IRS might approach a taxpayer and present the benefits that the taxpayer might achieve by undertaking an APA. The IRS reserves the right in all cases to either not accept an APA request, or to terminate the consideration of an APA request 'if the request or the continued development of the case is contrary to the principles of sound tax administration'.[127] Filing an APA request with the Service does not suspend any on-going examinations or prevent pending enforcement proceedings from moving forward. However, the IRS will, in such cases, coordinate its activities to avoid duplicating information requests, interviews, site visits and other compliance burdens.[128]

There are three types of APA agreements that a taxpayer can request: Bilateral agreement; multilateral agreement; or a unilateral agreement. A unilateral APA involves an agreement only between the taxpayer and the IRS. A bilateral or multilateral APA includes other foreign tax authorities

123. *Ibid.*
124. *Ibid.*
125. *Ibid.*
126. *Ibid.*
127. IRS Rev. Proc. 2006-09, 2006-1, C.B. 278.
128. *Ibid.*

beyond the IRS. A bilateral or multilateral APA application includes a written request for a mutual agreement between/among the various competent authorities that will be involved in the agreement. In an effort to avoid double taxation problems that could result from an APA, the IRS encourages all APA applicants to pursue a bilateral or multilateral agreement through the mutual agreement procedures (MAPs) contained in the tax treaty or treaties between the various countries and the United States.

Regardless of the type of APA agreement that a taxpayer requests, the process for negotiating an APA is fairly consistent. The APA process consists of four steps that are intended to help facilitate a timely and reasonable conclusion to an APA request.

4.3.2.1. Step 1: APA Application

While not mandated, the Service encourages taxpayers that are considering an APA to request a pre-filing conference (PFC). A PFC is an informal discussion between the IRS and the taxpayer regarding the appropriateness of an APA given the taxpayer's facts and circumstances. The primary purpose of the PFC is to clarify the types of information, documentation, and analysis that the IRS will need when considering the application. The PFC is also an appropriate time to discuss the timing and scheduling issues associated with completing an agreement.

The taxpayer has the option to request this conference on an anonymous basis.[129] If the taxpayer elects to identify itself, it must disclose to the APA Program whether any of the contemplated transactions proposed for the APA are under review by the IRS either in an audit or other legal proceeding.[130] Regardless of whether or not the taxpayer identifies itself, it must send a pre-filing notification to the APA Program at least one-week prior to the meeting that lists the persons (for an anonymous filing, the first names or job titles of those people attending is sufficient) who will be attending, and an outline of the issues and topics that will be discussed.[131]

Following the PFC, if the taxpayer elects to move forward with an APA, it must file a formal request with the IRS. The IRS has spelled out the specific items that should be included in an APA request in Rev. Proc. 2006–2009. Unless otherwise agreed to by the Service and the taxpayer, the application should include the following information:

- comprehensive table of contents;
- contact information (e.g., contact names, phone numbers, addresses, taxpayer ID number etc.) for the companies or organizations engaging in the proposed covered transactions;

129. *Ibid.*
130. *Ibid.*
131. *Ibid.*

- controlling taxpayer's industry within the Large and Mid-Size Business (LMSB) division;
- completed Form 2848 (Power of Attorney and Declaration of Representative) for any person(s) or organization(s) that are authorized to represent the taxpayer regarding the APA request;
- overview of the taxpayer's operations and its history, organizational charts (e.g., legal and operational), financial arrangements and major transaction flows;
- description of the transaction(s) covered under the APA request and the estimated dollar value of each covered transaction;
- Statement addressing the extent to which the tested party has transactions involving commission sales and ordinary distributions sales (i.e., buying v. reselling);
- detailed information (e.g., functions, risks, assets, contractual terms etc.) for each party involved in the proposed covered transaction(s);
- copies of principal written agreements that detail the contractual terms of the proposed covered transaction(s);
- financial and tax data (e.g., Form 5471, Form 5472, tax returns, financial statements, annual reports, transfer pricing documentation, marketing and financial studies etc.) for the parties to the proposed covered transactions for the last three taxable years;
- discussion of the functional currency of the parties to the proposed covered transaction(s);
- taxable year of each party to the proposed covered transaction(s);
- description of any significant financial accounting methods employed by the parties that might have an impact on the proposed 'TPM';
- overview of any substantial tax and financial accounting differences between the United States and the foreign countries associated with the proposed covered transaction(s);
- discussion of any relevant statutory provisions, tax treaties, court decisions, regulations, revenue rulings, or revenue procedures that relate to the appropriateness of the proposed TPM for the requested APA;
- explanation of any previous or current issues at the examination, appeals, judicial, or competent authority levels that relate to the proposed transactions or TPM;
- description of any previous APAs or rulings, by foreign tax authorities, relating to the proposed covered transaction(s) or TPM;
- overview of the industry's pricing strategies and economic conditions in the geographic regions covered by the proposed APA;
- list of the taxpayer's competitors and a discussion of any relevant uncontrolled transactions and business practices that are similar to what is found in the APA request;

- explanation of the proposed TPM and why such a method(s) meets the best-method rule found in Treasury Regulation §1.482-1(c);
- description of the research efforts and criteria used to identify and select third party comparables;
- detailed data (e.g., financial data, license agreements) for the selected independent comparables in both print and electronic formats;
- explanations of any adjustments to the selected comparables' financial data;
- illustration of the application of each proposed TPM by applying the TPM, in a consistent format, to the financial and tax data of the parties to the covered transactions for the prior three taxable years.

For those taxpayers that are seeking an APA related to a CSA, the IRS will request additional information from the applicant, including a copy of the cost-sharing agreement, the method for allocating costs among participants, the buy-in agreement and other similar information. A detailed listing of necessary documents is found in IRS Rev. Proc. 2006-2009.

The taxpayer is required to pay a filing fee for each APA request. The fee for an APA request is USD 50,000, the fee for an APA renewal request is USD 35,000 and the fee for a small business[132] APA is USD 22,500.[133] The fee to amend an APA request or to amend a completed APA is USD 10,000.[134]

After the APA team leader assigned to the case receives a complete application, the leader will distribute copies of the application to all team members. The team leader is also responsible for making initial contact with the taxpayer to confirm receipt of the complete application, and to schedule an opening conference with the taxpayer. The IRS attempts to hold an opening conference within forty-five-days of receiving a complete application. During this initial meeting, both the IRS and the taxpayer will develop and agree to a Case Plan that serves as the blueprint for completing the APA in a timely fashion.

4.3.2.2. Step 2: Due Diligence and Analysis

During Step 2, the APA team will conduct a detailed review of the taxpayer's APA request. The IRS, after reviewing the taxpayer's request, can issue a list of questions or request additional information to help in the analysis. It is important to note that the questions and information requests that arise during

132. A taxpayer requesting an APA as a small business must have gross annual income of less than USD 200 million or the aggregate value of the transaction does not exceed USD 50 million annually or USD 10 million annually with respect to a covered transaction involving intellectual property.
133. IRS Rev. Proc. 2006-09, 2006-1, C.B. 278.
134. *Ibid.*

this process, 'will not constitute an examination or inspection of the taxpayer's books and records under §7605(b) or other provisions of the Code'.[135]

The IRS can also conduct site visits to the taxpayer's operations during Step 2 to better understand the covered transactions. The site visits can potentially uncover taxpayer functions or activities that may require additional refinement of the taxpayer's proposed TPM, or additional documentation to support the proposed TPM.

At the conclusion of Step 2, the IRS will engage in discussions with the taxpayer concerning various aspects of the APA request. Areas of discussion typically include selected comparables, the TPM and various proposed adjustments to the financial data. The APA team leader will also elevate key issues to his managers for additional guidance on how best resolve these open items.

4.3.2.3. Step 3: Negotiation and Agreement

This step differs for bilateral and unilateral APA requests. In the case of a unilateral APA all negotiations occur between the taxpayer and the APA team. The two sides work together to reach an agreement. When an agreement is reached, the APA team leader will solicit input from IRS field personnel who are assigned to the case. The fields' approval and disagreements are noted in the final memorandum that the APA team leader prepares and submits to the taxpayer with the final APA for review and execution.

The negotiation and approval process for a bilateral APA is more involved, and it typically proceeds along two parallel tracks. On the first track, the APA team will work with the taxpayer to develop a recommended position that can be presented to the foreign tax authorities that are parties to the APA. This recommended position is first presented to the US Competent Authority as the approach that should be taken in negotiations with the US treaty partners through the second track, as will be discussed below. The recommended position is a formal written document that provides the IRS' view of the best TPM for the covered transactions, after taking into consideration the relevant tax law, case history, regulations, tax treaty and the previous experience with the treaty partner. The APA Director must review and approve the recommended position before presenting it to the treaty partner(s).

The second track involves negotiations between the US Competent Authority and the treaty partner. The US Competent Authority will take the APA team's recommendation (as developed in the first track discussed above) and will prepare a final negotiation position, which is formally transmitted to the foreign tax administrator's representative. The negotiation

135. *Ibid.*

process is typically done in face-to-face sessions between both tax authorities. When appropriate or necessary, the US Competent Authority can request the assistance of APA Program staff in the negotiations. Once an agreement is reached, the APA team leader will follow the same process that is done for a unilateral APA, including the solicitation of input from field staff, and a cover memorandum to the final agreement that describes the feedback from the field and the APA team.

4.3.2.4. Step 4: Drafting, Reviewing and Executing the Agreement

This final step is initiated when the IRS, taxpayer, and in the case of a multilateral APA, the foreign tax authorities have reached an agreement on the TPM. The IRS uses standard language that is incorporated into every APA. The final agreement is reviewed and approved by the APA Branch Chief and the APA Director. The APA Director executes the agreement on behalf of the IRS and an appropriate corporate officer does the same for the taxpayer.

4.3.3. Other Considerations

Prior to executing the APA, a taxpayer may withdraw its request for an APA. However, the filing fees generally will not be refunded if the taxpayer withdraws its APA request after the IRS has initiated it due diligence efforts.[136] The APA Program also reserves the right to not accept any APA request or to deny an APA after the request has been accepted. If the APA Program elects to reject a request, the taxpayer will be permitted a meeting with the APA Director to discuss the reasoning behind the IRS' decision.[137]

A taxpayer may also request that the TPM be applied to prior tax years that are not covered by the APA.[138] The taxpayer may submit its rollback request at any time prior to the execution of the APA. Rollback requests that are filed after the submission of the APA request must be in writing and addressed to the APA Director. The IRS will carefully consider the facts and circumstances surrounding a rollback request, specifically the number years covered by the request, and the status of on-going examinations that might involve the proposed transactions.

An approved APA is a binding agreement between the Service and the taxpayer. The agreement is limited to the covered taxpayer, agreed upon taxable years and the transactions to which the APA specifically applies.[139] Neither the taxpayer nor the IRS may introduce the APA and any written or

136. *Ibid.*
137. *Ibid.*
138. *Ibid.*
139. *Ibid.*

oral representations made in the process of negotiating the agreement as evidence in any judicial or administrative proceeding regarding any tax year, transaction or person not covered by the APA.[140] The only exception is if the taxpayer and the IRS agree to do so in a formal written agreement, or it is mandated by subsequent regulation. Similarly, in the case of a cancelled or revoked APA request, the associated information may not be used by either side in a judicial or administrative proceeding involving any taxable year of the requested APA term.[141]

4.3.4. Administering and Renewing the APA

The taxpayer is required, by statute, to file a timely and complete annual report for each tax year that the APA covers. The report should document the taxpayer's compliance with the APA's terms and conditions. The report should also include, as appropriate, any discussion about amending, renewing or cancelling the APA. If the taxpayer determines that any of the information it submitted to the IRS during the APA negotiation process was incomplete, incorrect or false, it must document this in the annual report. The taxpayer must declare that all of the information contained in the annual report is 'true, correct, and complete'.[142]

The taxpayer is obligated to maintain and retain complete and accurate books and records that the IRS could use to determine compliance with the APA. The IRS can issue a formal document request for information related to compliance with the APA, and the taxpayer is obligated to provide requested documents within thirty-days of receiving the request.[143]

The IRS may revoke or cancel an APA if the taxpayer is guilty of fraud or malfeasance with regard to the material facts and information that the Service relied upon when negotiating the APA. Also, failure to file an annual report or to comply with any of the provisions set forth in the APA can result in the cancellation of the APA. Finally, in the event that a critical assumption that was relied upon when negotiating the APA fails to materialize, the Service will cancel the APA, unless the parties agree to revise it.[144]

A taxpayer can elect to renew an APA by following the same procedures for an initial APA request. The taxpayer is encouraged to file a renewal request at least nine month prior to the date that the existing APA will expire. The taxpayer is also encouraged to request a pre-filing conference to discuss the most efficient manner to renew the agreement. The IRS strives to expedite

140. *Ibid.*
141. *Ibid.*
142. *Ibid.*
143. *Ibid.*
144. *Ibid.*

renewal requests, especially if the facts and circumstance are not materially different from the original filing.

4.3.5. Conclusion

The APA Program can help taxpayers resolve actual or potential transfer pricing disputes with the IRS and foreign tax authorities. It can be a more cost effective option than the traditional examination process (e.g., annual audits, appeals and litigation), especially when the taxpayer is looking for a high-degree of certainty that a particular intercompany transaction will be upheld by the IRS and foreign tax authorities. The process is not without its challenges, as the time to complete an APA can be lengthy, requiring a considerable commitment of time and resources by the taxpayer. This is why the IRS encourages all taxpayers who might be considering an APA to request a pre-filing conference to discuss the appropriateness, process and expectations of all parties involved in the APA.

4.4. State and Local Tax Considerations

Despite efforts to impose uniformity[145] in how the fifty states tax businesses engaged in interstate commerce, the patchwork of state and local tax policies often resembles what a multinational taxpayer faces when doing business in multiple countries. For example, some states require a taxpayer to file and report its income on a unitary basis, (i.e., all domestic income, whether it is generated inside the taxing jurisdiction or not, is subject to taxation).[146] States that employ this filing method are commonly referred to as 'Unitary States'. Other states require a taxpayer to report income derived from only those businesses that have sufficient economic and legal ties (i.e., nexus) to that jurisdiction. The states that employ this filing method are commonly referred to as, 'Separate Return States'. Because of different income tax filing rules and varying tax rates across the different states, many taxpayers with US operations have utilized transfer pricing as a tool to reduce their effective state tax rate by shifting income among the states where they have a tax filing obligation.

145. The Multistate Tax Compact is intended to: Facilitate the proper determination of state and local tax liabilities for multistate taxpayers; promote uniformity; facilitate taxpayer convenience and compliance in filing tax returns across multiple jurisdictions; and avoid duplicative taxation. Source: Multistate Tax Commission Website, <www.mtc.gov>.

146. Some states like California include a 'Water's Edge Election' that permits a domestic taxpayer or the tax administrator to either include or exclude foreign-based income in its apportionable state income.

Table 13.4. State Corporate Income Tax Filing Requirements

No Corporate Income Tax	*Separate Return*	*Combined Reporting*	*Considering Combined Reporting*[*]
Nevada	Arkansas	Alaska	Alabama
South Dakota	Delaware	Arizona	Connecticut
Washington	Georgia	California	Florida
Wyoming	Indiana	Colorado	Iowa
	Kentucky	Hawaii	Louisiana
	Mississippi	Idaho	Maryland
	New Jersey	Illinois	Missouri
	Ohio	Kansas	New Mexico
	Oklahoma	Maine	North Carolina
	Pennsylvania	Massachusetts	Rhode Island
	South Carolina	Michigan	Tennessee
	Virginia	Minnesota	
		Montana	
		Nebraska	
		New Hampshire	
		New York	
		North Dakota	
		Oregon	
		Texas	
		Utah	
		Vermont	
		West Virginia	
		Wisconsin	

[*] States considering combined returns are separate return jurisdictions.

State tax planning gained momentum in the 1990s as taxpayers and their advisors began leveraging successful international tax planning structures in a domestic context. One of the more popular and successful state tax planning strategies was the Delaware Passive Investment Company (PIC). Delaware's tax rules exclude passive income from state taxation. When implementing this strategy, the taxpayer transferred intangible assets (e.g., trademarks, patents, copyrights and similar assets) into a Delaware subsidiary, and imposed a royalty on the income that related parties generated from using these assets in their regular course of business. The royalty payments from the operating entities reduced taxable income in non-unitary states where the income was generated.

Over time, the domestic tax structures and associated transfer pricing arrangements have become more sophisticated. Taxpayers implement intercompany charges for management services, intercompany loans and receivables aimed at reducing the taxpayer's overall effective tax rate. The state tax authorities have also become more aggressive in challenging domestic tax structures that have a negative impact on state revenue collections. The challenges have come in the forms of increased audit activity, taxpayer litigation and new laws that seek to limit the ability of taxpayers to shift income from one jurisdiction to another to avoid paying taxes.

4.4.1. State Adoption of Treasury Regulation Section 1.482 Principles

Many states have (i) adopted 482-type powers explicitly from statute; (ii) implicitly adopted 482-type powers from the state's IRC conformity statute;[147] or (iii) incorporated laws that are similar in nature to 482, but that do not adopt 482 specifically.

Many taxpayers engaged in domestic tax planning that involves intercompany transactions are preparing transfer pricing documentation that incorporates Treasury Regulation §1.482 analyses, similar to what is done for international tax purposes. In fact, taxpayers have successfully used transfer pricing documentation to defend against state challenges to royalty payments to related parties. For example, in a 2004 New York City Tax Appeals Tribunal case involving Toys 'R' US, the Tribunal wrote:

> Although there is no express statutory or regulatory incorporation of the IRC §[1-]482 arm's-length standard, decisions of the state Tax Appeals Tribunal . . . have consistently applied the principle of IRC §[1-]482 to determine whether the presumption of distortion is overcome and income is properly reflected.[148]

In other words, where the taxpayer, as in the case of Toys 'R' Us, can show arm's-length transfer pricing, the tax administrator cannot presume distortion unless it can be shown that the intercompany pricing was something other than arm's-length.

In several other cases, the reliance on transfer pricing documentation and arm's-length principles has met with very different results for the same taxpayer. Sherwin-Williams Company is a well-known manufacturer and

147. A state's conformity statute often takes the form of adopting the Internal Revenue Code by reference or by adopting federal taxable income as the starting point in determining a taxpayer's state income tax liability. Where 482 powers exist, the state tax administrator is generally given authority to make Section 482-type adjustments.

148. *In re* Toys 'R' Us-NYTEX Inc., TAT9E) 93-1039(GC) (N.Y. City Tax App. Trib. 14 Jan. 2004).

distributor of paints and coatings that are used for commercial, industrial and residential applications. The company is based in Cleveland, Ohio and has retail, manufacturing and distribution centres in the United States and abroad. Like other taxpayers, Sherwin-Williams had implemented a domestic tax structure that isolated the company's intellectual property (e.g., trademarks, trade names, product formula etc.) in a separate subsidiary. The IP company (i.e., 'licensor') entered into licensing agreements with related parties ('licensee') wherein the licensee could use the IP to generate income, and the licensor would receive a royalty payment for sales derived from using the IP. Sherwin-Williams had commissioned outside advisors, including tax, legal and transfer pricing professionals, to help set up the structure and prepare the appropriate supporting pricing documentation (e.g., intercompany agreements, licensing agreements and transfer pricing reports).

New York State's tax authority challenged Sherwin-William's IP licensing structure by saying that it lacked, among other things, economic substance. New York insisted that the taxpayer file its New York tax return on a combined basis with its intangible holding company. Sherwin-Williams provided the New York tax authorities with documentation (e.g., transfer pricing documentation) supporting the business purpose, substance and arm's-length nature of the intercompany charges. Ultimately, the case was decided on appeal when the New York Tax Appeals Tribunal ruled that the transaction, 'lacked economic substance' and ordered the taxpayer to file a combined franchise tax report in New York.[149] In Massachusetts, where Sherwin-Williams had the same fact patterns and support for the IP structure, the taxpayer prevailed and Sherwin-Williams was not forced to report or add-back the IP income on its Massachusetts tax return.[150] In both cases, the state taxing authorities hired outside transfer pricing consultants to review the taxpayer's transfer pricing documentation to ensure that the pricing was arm's-length. In the New York case, the issue of economic substance, not the transfer pricing, was the deciding factor. In Massachusetts, the taxpayer successfully substantiated a business purpose, substance and the arm's-length nature of the intercompany royalty charge.

Other court cases that provide insight into state responses to intercompany royalty and service charges include the *Lanco, Inc.* case in New Jersey,[151] the *Kmart* case in New Mexico,[152] *the A&F Trademark* case in North Carolina[153] and the *MBNA* case in West Virginia.[154] In all of these cases, the tax

149. *Sherwin-Williams Co. v. New York Tax Appeals Tribunal*, No. 2004, N.Y. App. Div., 28 Oct. 2004.
150. *Sherwin-Williams Co. v. Massachusetts Comr. of Rev.*, 778 N.E. 2d 504 (Mass. 2002).
151. *Lanco, Inc. v. Director, New Jersey Division of Taxation*, 908 A2.d 176 (N.J. 2006).
152. *Kmart Corp. v. Taxation and Revenue Department*, 131 P.3d 22 (N.M. 2006).
153. *A&F Trademark Inc., v. Tolson*, 605 S.E. 2d 187 (N.C. Ct. App. 2004).
154. *Tax Commissioner v. MBNA America Bank*, 640 S.E. 2d 226 (W. Va. 2006).

authorities successfully argued legal principles (e.g., nexus standards) rather than 482 transfer pricing issues to deny the intercompany charges between related parties.

4.4.2. Other State Mechanisms

The state tax authorities have had mixed results either in imposing 482-type powers or in litigating the legality of intercompany charges before the courts. In response to the mixed success and the continuing demand to generate increased tax revenues, many of the states are turning to legislative solutions to help eliminate the use of intercompany charges to reduce taxable income. There are two specific areas that have seen the most activity: A movement from separate returns to combined returns, and the disallowance of certain intercompany expenses.

In 2003, thirty states employed a separate return filing system for corporate taxpayers. The remaining twenty states either used a combined reporting system or imposed no corporate income tax on companies. By 2009, seven new states had adopted combined reporting requirements to close the 'loophole' that allows corporate taxpayers in separate return states to move income from those states to low- or no-tax jurisdictions by means of intercompany charges.

Some states that impose a corporate income tax disallow certain deductions, or require a taxpayer to add back certain intercompany charges (e.g., interest and royalty expense). In these states, the tax administrator can utilize the add back provisions if it believes that the intercompany charge distorts the taxpayer's true taxable income for that jurisdiction. The recent trend has been for more states to either adopt intercompany expense disallowance authority or to expand that authority to include more types of expenses that the tax administrator can disallow. At the narrow end of the spectrum, states like North Carolina and Oregon provide the state tax administrator with the power to disallow intercompany royalty deductions.[155] Other states, such as Virginia, New Jersey, Alabama and Arkansas have given expanded authority to disallow any interest related to intercompany loans. Finally, Kentucky,[156] South Carolina[157] and Wisconsin[158] have enacted broad powers that allow their respective tax administrators to disallow intercompany expenses beyond intercompany interest and royalty payments.

155. Oregon's disallowance rule permits the tax administrator to disallow a royalty payment to a recipient outside the combined reporting group.
156. Management fees, but only intangible interest is disallowed.
157. If the intercompany expense is accrued buy not paid.
158. Includes intangible expenses and management fees.

As state legislatures continue to close loopholes and eliminate tax filing systems that permit the movement of income from a high-tax to low-tax or no-tax jurisdictions by means of intercompany pricing, the need for 482-type transfer pricing studies at the state level will diminish. Of course, there will continue to be on-going litigation involving transfer pricing studies at the state-level for open audit years prior to the enactment of combined reporting and add back legislation. There are also on-going associated tax accrual considerations related to taxpayers' financials statements.

4.5. Tax Audits and Related Controversy Procedures

4.5.1. Request for Documentation

The Service has developed extensive policies and procedures surrounding transfer pricing examinations and dispute resolution. With the inception of section 6662, taxpayers have been required to compile transfer pricing documentation prior to the timely filing of each year's tax return and to produce such documentation to the IRS within thirty days of the dates requested. (see section 3).

While documentation requirements have been in place for many years, taxpayers were not consistently requested to produce their ten principle documents and transfer pricing positions were not consistently audited by field examiners. With the goal of improving transfer pricing compliance, on 22 July 2003, the LMSB issued a Commissioner Directive to the field that required and/or reiterated:

- that the examiner make a written request for transfer pricing documentation to be produced within thirty days;
- that the request for documentation be made at the opening conference;
- that for such documentation to meet the requirements under Treasury Regulation §1.6662(d)(2)(iii), it must have been in existence by the timely filing of the return; and
- that if no documentation exists, a formal information request must be issued regarding the taxpayer's transfer pricing practices and results.

The directive also made it clear that transfer pricing documentation should be reviewed and evaluated by either an international examiner or an economist, and that if penalties are triggered by the adjustment, they must be reviewed and imposed by the Penalty Screening Committee.

Once the IRS has reviewed the principle documents received from the first thirty-day request, it can then also request, under another thirty-day letter, supporting documents.

4.5.2. Notice of Adjustment

When the IRS is not in agreement with the taxpayer's transfer pricing result, the IRS will typically issue a 'Notice of Proposed Adjustment' on a form 5701. This document generally contains the IRS' factual understanding, an application of tax law and a conclusion. If the taxpayer disagrees with the IRS' position, they can respond informally or formally in an attempt to mitigate the issue. If the issue remains unresolved, then the IRS will issue a formal thirty-day letter to the taxpayer, proposing a deficiency in tax. In response, the taxpayer can write a formal protest and request consideration by the IRS Office of Appeals. Typically, the examination team will write a formal response to the taxpayer's protest.

4.5.3. Appeals and Alternative Dispute Resolution

Appeals are charged with settling cases based on an independent review, taking into consideration the hazards of litigation. Generally, the process of moving a case from examination into Appeals is quite slow, usually taking somewhere between six and twelve months. This is at least in part because of the time required for the taxpayer to write and submit its protest, and the time required for the examination team to respond.

In order to expedite the resolution of tax issues presented to Appeals, the IRS has developed several alternative dispute resolution mechanisms. Five major programs in place are:

- Appeals Fast Track Settlement Procedure;
- Early Referral to Appeals;
- Delegation Orders;
- Appeals Mitigation and Arbitration; and
- Advanced Pricing Agreement Program.

4.5.3.1. Appeals Fast Track Settlement Procedure

Where an examination dispute involves a limited number of issues, the taxpayer may apply for a fast track settlement. If accepted into the program, the outstanding issues can be resolved within 120 days.

Once the Notice of Proposed Adjustment is issued, rather than receiving a thirty-day letter from the IRS, the taxpayer can request that an Appeals officer be assigned to the case while the case is still in the audit team's jurisdiction. During the Fast Track process, the Appeals officer acts as a mediator between the taxpayer and the examination team. In the event that no resolution can be reached, the taxpayer can still accept a thirty-day letter and go to Appeals for consideration. At Appeals, the taxpayer's case will be reviewed by a new Appeals Officer.

4.5.3.2. Early Referral to Appeals

If during the course of an on-going examination it is clear that a particular issue will need to be resolved in Appeals, the issue may be referred to Appeals while the examination continues in relation to other issues.

4.5.3.3. Delegation Orders

Once the resolution of an issue is reached in Appeals, it is possible to take that resolution and apply it to other years under examination. Under Delegation Order 236, an examination team manager is delegated the authority to accept settlement effected by Appeals with respect to the same issue in previous or subsequent years, even if the settlement is based in whole or in part on the hazards of litigation. Delegation of such authority to the manager is available if:

- the facts of each transaction are substantially the same;
- the legal authority is unchanged; and
- the issue was settled by Appeals independently of other issues under consideration.

Issues designated as 'Coordinated' may also be settled under Delegation Order 4-25.[159]

4.5.3.4. Appeals Mitigation and Arbitration

If an Appeals officer and the taxpayer are unable to reach an agreement, both mediation and arbitration are available to resolve the open issues.

Utilizing the mediation program, the taxpayer may select, subject to IRS approval, an independent mediator. The goal of the mediator is to assist the Appeals officer and the taxpayer in framing the relevant issues and negotiating a settlement. The mediator has no settlement authority over the case.

In disputes over the facts surrounding the points at issue, the taxpayer may utilize the arbitration program. In this program, an independent arbitrator approved by both parties holds a hearing and issues a finding of facts report within thirty days after the hearing. The determination of the arbitrator is binding, and it cannot be appealed through litigation.

159. An Appeals Coordinated Issue is an issue or category of case of Service-wide impact or importance that requires Appeals' coordination to ensure uniformity and consistency nationwide. This is achieved through the coordination of efforts between appeals officers and designated ACI coordinators. <www.irs.gov>.

4.5.3.5. Advanced Pricing Agreement Program

As discussed in section 4.3, the APA Program provides a voluntary process whereby the IRS and taxpayers may resolve transfer pricing issues. Generally speaking the APA program is prospective in nature. This means that an APA typically sets forth the best method of analysis in advance of the transactions actually occurring. However, the taxpayer can request that the IRS consider a rollback in connection with their APA request. That is, the APA team may be willing to take an agreed upon method under an APA and apply it to earlier years that are still open to audit. Taxpayers may consider applying for an APA even before an examination begins, especially is there is reasonable uncertainty related to specific transactions that span several open and future years.

5. SIGNIFICANT US TRANSFER PRICING LITIGATION

While the general concepts of transfer pricing law are fairly simple to state and define, the proper application of transfer pricing concepts is extremely dependent on the facts and circumstances of the case. The analysis of such fact patterns by the courts has implicated both law and regulatory guidance.

There have been hundreds of cases decided under section 482 and its predecessors since the turn of the century. However, a handful of cases have shaped the way the 482 Regulations are broadly interpreted, and/or have served as catalysts for regulatory evolution. These cases are discussed below.

5.1. *Asiatic Petroleum Co. v. Commissioner* (1936)[160]

5.1.1. Case Summary

In 1929, a US taxpayer sold the shares of a US subsidiary to a related company in the Netherlands. The shares were sold for an amount equal to the taxpayer's cost basis in the stock. The Dutch affiliate then sold the shares of the newly acquired company to a third party at a market price that was materially higher than what the taxpayer had charged.

The Courts found that the back-to-back sales were structured to avoid paying US tax on the gain, and found that the Commissioner had the legal

160. *Asiatic Petroleum Co. v. Comm'r*, 79 F2d 234 (2d Cir. 1935), XV-1 CB 181 (1936).

authority under section 45 of the Revenue Act of 1929 to allocate this gain to the taxpayer.

5.1.2. Commentary

This early victory by the government set the standard for a rather broad application of the government's ability to reallocate income when it can be demonstrated that this income was allocated to foreign affiliates for the purpose of reducing tax.

5.2. *PPG Industries, Inc. v. Commissioner* (1970)[161]

5.2.1. Case Summary

A US parent was a manufacturer, and established a foreign subsidiary to expand the sale of its products outside of the US. The foreign subsidiary was established in a low tax jurisdiction and was fully staffed to engage in international business. The subsidiary was responsible for selling product into foreign markets, expanding foreign markets and overseeing the parent's foreign investments. The subsidiary bore the related risks of such activities. The parties entered in to an intercompany agreement that set pricing terms and outlined each party's role and responsibilities.

The Service claimed that for 1960 and 1961 there was a deficiency in the parent's income under section 482. The examiner made this determination based on publicly available statistical data relating to wholesalers in different industries. The agent claimed that the deficiency amount was the profit earned by the subsidiary in excess of the 'industry norm' as set out in the statistics manual.

The court found that no deficiency existed because no evidence was presented that showed that the unnamed companies utilized in the manual were comparable to the foreign subsidiary. The court was also moved by evidence presented by PPG showing that the foreign subsidiary could have purchased similar product from competitors at lower prices.

5.2.2. Commentary

This is one of the first transfer pricing cases focused on the issue of pricing methodologies. The court showed a clear preference for comparable data, rather than general statistics. In addition, the fact that the subsidiary was established in a low tax jurisdiction was not a controlling factor in and of

161. *PPG Indus., Inc. v. Comm'r*, 55 TC 928 (1970).

itself. Rather, the court was more concerned with whether or not the subsidiary had the economic substance to conduct and bear risk associated with the business attributed to it.

5.3. *EI DuPont de Nemours & Co. v. United States* (1979)[162]

5.3.1. Case Summary

The US parent formed a foreign trading subsidiary in a low tax jurisdiction. The subsidiary purchased product from the parent and then sold that product to unrelated customers. The US Parent guaranteed the subsidiary 75% of the profits earned on the final sale if the sale proved profitable to the company, or full cost reimbursement if the sale proved to be at a loss. Therefore, the subsidiary was insulated from ever earning losses.

While the subsidiary was fully staffed to perform its function, and thus had business purpose, evidence presented in the case demonstrated that the primary driver for establishing the subsidiary was to shift US income overseas and shelter it from US tax. In addition, evidence was presented that demonstrated that no principled reason was used in setting prices to the foreign subsidiary other than to insure the subsidiary of profits.

Experts were presented on both sides. The taxpayer's experts worked to defend the profit split utilized by the company, but acknowledged that the fact that the foreign subsidiary did not bear business risk compromised their analysis.

One of the experts for the government was Charles Berry. During his testimony, Professor Berry introduced the 'Berry Ratio' pricing concept. Utilizing the Berry Ratio, Professor Berry demonstrated that the majority of the profits was appropriately reallocated to the US taxpayer.

5.3.2. Commentary

In this case, the court found that while the subsidiary had a business purpose, the functions it performed and the risks it did or didn't bear did not support the use of a profit split. In addition, the court was clearly moved by evidence demonstrating that the establishment of the subsidiary and the setting of prices was primarily tax driven.

The government's expert introduced a profit-level indicator (the Berry Ratio) that ultimately was incorporated in the US Regulations in 1993.

162. *EI DuPont de Nemours &Co. v. United States*, 608 F2d 445 (Ct. Cl. 1979).

5.4. *Hospital Corporation of America v. Commissioner* (1980)[163]

5.4.1. Case Summary

Hospital Corporation of America (HCA) owned and managed several hospitals in the US, and as a result of conducting this business over several years had developed general practices, policies, and expertise, much of which existed in written form.

In 1972, HCA was asked to manage a hospital in the Middle East. The company established a series of Cayman subsidiaries to house its non-US operations and to enter into the management contract related to the foreign hospital. The Cayman companies had few employees and relied on HCA for various services.

The Tax Court found that the Cayman companies relied heavily on both US services and intangible assets to procure the foreign contract, and then to manage the hospital. Based on this finding of fact, the Court, in its best judgment, allocated 75% of the profits related to the foreign contract to the United States under section 482.

5.4.2. Commentary

In this case, intangible assets were broadly defined to include personnel and management systems. Another point to note is that while the Court found that the Cayman subsidiaries benefited from services and intangibles, they reallocated income based on a profit split concept, rather than attempting to quantify payments for services and for the use of intangibles.

5.5. *Eli Lilly & Co. v. Commissioner* and *G.D. Searle & Co. v. Commissioner* (1987)[164]

5.5.1. Case Summary

In both cases, the US taxpayer established a manufacturing subsidiary in Puerto Rico and transferred to it manufacturing intangibles and drug patents through valid section 351 transactions.[165] Income earned by the Puerto Rico

163. *Hospital Corp. of Am. v. Comm'r*, 81 TC 520 (1980).
164. *Eli Lilly & Co. v. Comm'r*, 84 TC 996 (1985), *G.D. Searle & Co. v. Comm'r*, 88 TC 252 (1987).
165. In s. 351 transactions, parent companies can contribute certain intangible assets to subsidiaries in exchange for stock with no tax consequence.

subsidiaries was exempt from Puerto Rican and US tax under the principles of section 931.

In both cases, profitable product lines were moved to the subsidiaries, with product either being sold back to the US parent for distribution, or directly to third party distributors. In addition, the US parent continued to provide services to the subsidiary, including R&D activities and regulatory services, among others. In each case, transfer prices were set such that the US parent earned income reflective of any marketing, sales and other services provided, but did not include compensation for the value of IP transferred, nor did the pricing acknowledge IP that was not transferred.

5.5.2. Commentary

In each case, the Court found that an allocation under 482 was warranted even though the intangibles in question were transferred in exchange for equity. In The G.D. Searle case, the Court stated succinctly:

> In an arm's-length situation, it would be the height of mismanagement to transfer the lion's share of the corporation's income solely for non-income producing stock and the right to perform compensated services for the transferee corporation.[166]

This meant that taxpayers were not exempt from 482 scrutiny even when IP was transferred through a valid section 351 transaction. In addition, the Court, in its best judgment, applied profit split type analyses to calculate the amount of enterprise profit belonging at the US parent in each case.

5.6. *Bausch & Lomb, Inc. v. Commissioner* (1989)[167]

5.6.1. Case Summary

The taxpayer owned the intellectual property related to the technology and manufacture of soft contact lenses, as well as the trademarks under which the lenses were sold. Several years after penetrating the United States and foreign markets, the taxpayer established an Irish manufacturing subsidiary with the purpose of manufacturing soft lenses for the European market.

166. *G.D. Searle & Co. v. Comm'r*, 88 TC 252, 370 (1987).
167. *Bausch & Lomb, Inc. v. Comm'r*, 92 TC 525 (1989).

The taxpayer received a royalty of 5% for the use of its intellectual property. In certain years, the Irish subsidiary sold more than 50% of its product to the taxpayer, rather than to European distributors. The taxpayer then sold the lenses in the US market, acting as a distributor for the Irish affiliate. The taxpayer paid a transfer price to the Irish subsidiary for each purchased lens, in addition to receiving a royalty.

The Service argued that the two flows, the royalty and the tangible product purchase price, ought to be combined and set such that the Irish manufacturer earned a contract manufacturing return.

The court found that since the taxpayer was not obligated to purchase product from the Irish manufacturer, the foreign affiliate could not be characterized as a contract manufacturer. The court thus agreed with the taxpayer's use of two separate intercompany flows.

To support the prices charged for lenses, the taxpayer presented market data demonstrating that the purchase price was arm-length. The Commissioner believed that the market evidence was not comparable to the intercompany lens transfers, and proffered that when comparing gross markups with those of comparable companies, the prices would have been less than half than what was charged to the United States.

The court found that the market evidence could be adjusted, primarily for differences in freight and duty. In addition, the Court discounted the Commissioner's position that significant volume differences should be used to discount otherwise comparable transactions. Therefore, the price charged for lenses by the Irish manufacturer to the taxpayer suffered only minor adjustment by the court.

However, the Court did find that the Irish manufacturer simply provided the capital investment necessary to establish and maintain its manufacturing facility, and that it bore relatively modest risk in relation to the taxpayer. It therefore rejected all 'comparable' agreements offered by each side and in essence applied a profit split to determine an arm's-length royalty. This was done by allowing the Irish entity to earn a risk premium in addition to a routine return on its capital investment, with the remaining profit allocated to the US taxpayer.

5.6.2. Commentary

As it related to tangible property flows, the Court, yet again, showed a strong preference for the use of CUPs. It also continued its use of the profit split method in determining arm's-length returns for manufacturing facilities established offshore that utilize intellectual property developed in the United States, even when neither party utilized this approach in addressing the Court.

5.7. *Westreco, Inc. v. Commissioner* (1992)[168]

5.7.1. Case Summary

The US taxpayer provided R&D services to a foreign parent. The Service argued that when comparing the US company to a set of fifteen companies identified through a Standard Industrial Classification (SIC)[169] search, it ought to have earned a higher markup on cost than it received.

The taxpayer argued that since it was paid regardless of the results stemming from its R&D efforts, that it bore significantly less risk than stand alone R&D-type companies whose returns directly depended on the outcome of their activities.

The Court agreed with the taxpayer and accepted the argument that a company with relatively less risk would expect lower returns than a similar company that bore higher risk.

5.7.2. Commentary

This case, along with others, solidified the Court's position that expected returns are largely influenced by the riskiness of investment. These types of cased fuelled many tax planning strategies that worked to shift profits offshore by contractually shifting risk outside of the United States.

5.8. *Compaq Computer Corporation and Subsidiaries v. Commissioner* (1999)[170]

5.8.1. Case Summary

The taxpayer purchased components from its foreign subsidiary, located in Singapore. In Singapore, the company was able to achieve significant location savings relative to the cost of production in the United States. Prior to forming the subsidiary, the taxpayer had, on several occasions, attempted to build third party sourcing relationships with other Asian manufacturers, but was not successful due to quality concerns. In addition to sourcing components from its subsidiary, the taxpayer also sourced similar components from third party suppliers in the United States.

168. *Westreco, Inc. v. Comm'r*, 64 TCM 849 (1992).
169. The SIC code system is used to categorize companies by industry. Each major industry group is assigned a two-digit SIC code. Extensions of these codes to three or four digits indicate a narrower industry definition.
170. *Compaq Computer Corporation and Subsidiaries v. Comm'r* TCM 1999-220 (1999).

The taxpayer set its transfer pricing such that the savings achieved by manufacturing in Singapore remained offshore. At trial, the taxpayer argued that the prices it paid to its US suppliers were CUPs. It asserted that since there were no foreign third parties to compete with its subsidiary (because none were able to meet the quality specifications of the taxpayer), the subsidiary's competition was solely US-based, and therefore its subsidiary would be able to charge comparable prices at arm's-length.

The Court agreed that since there was no Asian competition to erode prices closer to marginal cost, the pricing between the taxpayer and the Singapore subsidiary was arm's-length.

5.8.2. Commentary

This case, along with a preceding case, *National Semiconductor and Consolidated Subsidiaries v. Commissioner*,[171] focus on whether or not location savings gained by establishing manufacturing facilities in lower cost jurisdictions should accrue to the parent or to the newly established subsidiary. In both cases, most, if not all of the location savings remained with the subsidiaries, and the Courts concluded that within reasonable bounds, this result is consistent with the arm's-length standard.[172]

5.9. *DHL Incorporated and Subsidiaries v. Commissioner* (2002)[173]

5.9.1. Case Summary

DHL established a foreign subsidiary shortly after the company's original formation. The foreign subsidiary was responsible for developing and managing DHL's document transportation business outside of the United States, and the taxpayer was responsible for developing and running the business domestically.

The DHL mark was legally owned in the United States. The foreign subsidiary used the DHL trademark royalty-free, but had made substantial foreign marketing investments since its inception, and was responsible for the foreign registration and maintenance of the mark overseas. After several

171. *National Semiconductor and Consolidated Subsidiaries v. Comm'r*, TCM 1994-195 (1994).
172. In the *National Semiconductor* case, the Court found that certain modest adjustments were warranted such that the US taxpayer was at least 'break even' in profitability in each year under review.
173. 285 F3d 1210 DHL *Corporation and Subsidiaries v. Comm'r*, US Court of Appeals, 9th Circuit, 11 Apr. 2002.

years, and prior to a sale of significant stock to a third party, the taxpayer transferred the rights to the mark to the foreign subsidiary for USD 20 million.

The Service adjusted the taxpayer's income to account for a larger purchase price associated with the mark, as well as for royalties that the Service believed should have been paid to the taxpayer in years prior to the mark's transfer. The Court found that the arm's-length purchase price for the mark should have been USD 100 million. In addition, the Court found that penalties associated with the purchase price adjustment as well as for the failure to make prior royalty payments were appropriate.

The taxpayer appealed the case on the grounds that the valuation that the Tax Court arrived at was not consistent with a valuation done at the time of the stock sale, which was done for the purpose of transferring the mark to a third party. The taxpayer also argued that the Court did not properly apply the Developer-Assister regulations outlined in the 1968 regulations,[174] and therefore allocated income associated with the foreign use of the mark erroneously.

The Court of Appeals upheld the valuation as determined by the Tax Court, and denied use of the lower valuation as it appeared to be a value deflated due to tax concerns, and one that offered no advantage or disadvantage to the third party purchaser. However, the Court of Appeals overturned the Tax Court's decision that the foreign subsidiary was neither a developer nor an assister under the 1968 regulations, and therefore reduced the adjustment to income by the amount attributable to the value of the mark outside of the United States. The Court of Appeals did not definitively state which role was appropriately attributable to the foreign subsidiary, but rather stated that in either role, the USD 50 million foreign mark value should either not have been transferred at all, or that the amount would have been more than offset by costs incurred by the subsidiary in developing the mark in its foreign markets.

The Appeals Court also found, with similar reasoning, that no royalties were due in years prior to the transfer of the mark, thus negating the related adjustments as well as the penalties.

174. Section 1.482-2d(2) of the 1968 Regulations address transactions involving intangible property where costs and/or risks are shared between parties in developing the property. When not in a cost sharing arrangement, one party is considered the 'Developer' (i.e., bears most risk, and provides the majority of the funding for development), and is compensated when the resulting intangible property is licensed to a third party. All other related parties are considered 'Assisters', and receive appropriate compensation at the time their contributions are made during the development period, but do not receive economic ownership of the resulting intangible property.

5.9.2. Commentary

In this case, the Court of Appeals found that while the taxpayer was the legal owner of the mark, it worked in partnership with its foreign subsidiary in creating value globally. While the Developer/Assister Regulations underwent material changes in the subsequent 1994 Regulations, the concept of economic ownership and its impact on the determination of consideration became firmly placed in case law.

5.10. *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner* (2006)

5.10.1. Case Summary

The IRS announced on 11 September 2006 that it reached a USD 3.4 billion settlement with the taxpayer. The settlement was the single largest in the history of the IRS.

The case centred around the relative value of product and trademark intangibles developed and owned by the UK parent, and sales and marketing intangibles developed by its US subsidiary. In its initial tax assessment, the IRS argued that since the UK-developed drugs at issue were not first to market, the value resulting from R&D efforts in the UK were not as critical to the products' US success as the sales and marketing intangibles developed by the taxpayer.

After initial tax assessments were made by the IRS, the taxpayer applied for Competent Authority relief of double taxation under the US – UK tax treaty. However, the Competent Authorities were unable to reach an agreement over the disputed income, and discussions were terminated in 2003.

5.10.2. Commentary

This case is noteworthy not only due to the size of the settlement but also because of its implications regarding the potential value of sales and marketing intangibles. Many international corporate structures resemble that of GlaxoSmithKline in that sales and marketing subsidiaries are established in local countries where these entities purchase and resell product developed and manufactured centrally. Typically, transfer prices are set such that sales and marketing subsidiaries earn a modest routine return, and that the residual profit or loss resides with the product IP owner/manufacturer. This case challenged this common place presumption and refocused many taxpayers and practitioners on the importance of a best method analysis under section 482.

5.11. *Xilinx, Inc. v. Commissioner* (2009)[175]

5.11.1. Case Summary

The taxpayer was involved in a cost sharing agreement with a foreign affiliate. Under its cost sharing agreement, the costs that were pooled and shared among its participants did not include stock-based compensation expenses. The Service adjusted the income of the taxpayer to reflect the sharing of such expenses with the participants of the agreement, because under the cost sharing regulations in effect at that time, 'all costs' related to the IDAs should be included in the pool.

The Tax Court found in favour of the taxpayer and overturned the allocation because the taxpayer was able to demonstrate to the Court that third parties involved in similar arrangements do not share stock-based compensation expenses. The Court accepted the proposition that since third parties do not share such expense, the arm's-length standard would dictate that this expense not be shared between the related parties engaged in the cost sharing arrangement.

The US Court of Appeals originally overturned the findings of the Tax Court, stating that the more specific language in the cost sharing regulations, which required that all costs be shared, cannot be nullified by the general language of Treasury Regulation §482-1(b)1 dictating that the arm's-length standard be applied in every case.

After significant pressure to preserve the arm's-length standard from various taxpayers and government officials, the US Court of Appeals withdrew their original decision and issued a new decision affirming the Tax Court's initial findings.

5.11.2. Commentary

The findings of this case are significant in that the US Court of Appeals originally determined that the arm's-length price need not meet the arm's-length standard in all cases. The amended opinion preserved the arm's-length standard and is likely to have far reaching implications on future transfer pricing litigation, specifically when its related to cost sharing matters.

6. LIST OF ABBREVIATIONS

AERR	Actually Experienced Return Ratios
AFR	Applicable Federal Rate
APA	Advance Pricing Agreement

175. *Xilinx, Inc. v. Comm'r*, US Court of Appeals, 9th Circuit, 27 May 2009.

CCA	Cost Contribution Arrangement
CFO	Chief Financial Officer
CIP	Coordinated Issue Paper
COGS	Cost of Goods Sold
CPM	Comparable Profits Method
CSA	Cost Sharing Arrangement
CUP	Comparable Uncontrolled Price
CUSP	Comparable Uncontrolled Services Price
CUT	Comparable Uncontrolled Transaction
ESUB	European Subsidiary
FAS	Financial Accounting Standard
FASB	Financial Accounting Standards Board
FIFO	First In, First Out
FIN	FASB Interpretation Number (No.)
GAAP	Generally Accepted Accounting Principles
GSMM	Gross Services Margin Method
HCA	Hospital Corporation of America
IDA	Intangible Development Activity
IDC	Intangible Development Costs
IP	Intellectual Property
IRC	Internal Revenue Code
IRS	Internal Revenue Service
LIFO	Last in, First Out
LMSB	Large and Mid-Size Business
MLTN	More Likely Than Not
OECD	Organisation for Economic Co-operation and Development
OEM	Original Equipment Manufacturer
PCT	Platform Contribution Transaction
PE	Permanent Establishment
PFC	Pre-filing Conference
PIC	Passive Investment Company
PP&E	Property, Plant and Equipment
PRRR	Periodic Return Ratio Range
RAB	Reasonably Anticipated Benefit
RPM	Resale Price Method
SCM	Services Cost Method
SFAS	Statement of Financial Accounting Standard
SIC	Standard Industrial Classification
TNMM	Transactional Net Margin Method
TPM	transfer pricing method
USD	United States Dollar
USP	Uncontrolled Services Price
UTP	Uncertain Tax Position