Chapter 5
Transfer Pricing

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¶501 WHAT IS TRANSFER PRICING?

The operating units of a multinational corporation usually engage in a variety of intercompany transactions. For example, a U.S. manufacturer may market its products abroad through foreign marketing subsidiaries. The same U.S. parent corporation also may provide managerial, technical, and administrative services for its subsidiaries. Another common arrangement is for a U.S. parent corporation to license its manufacturing and marketing intangibles to its foreign subsidiaries for exploitation abroad. A “transfer price” must be computed for these controlled transactions in order to satisfy various financial reporting, tax, and other regulatory requirements. Although transfer prices do not affect the combined income of a controlled group of corporations, they do affect how that income is allocated among the group members.

Example 5.1: USAco, a domestic corporation, manufactures small engines for sale both in the United States and abroad. Foreign sales are made through FORco, a wholly owned foreign corporation. USAco’s engines cost $600 to manufacture and $100 to market, and sell for $1,000 abroad (see Figure 5.1). Regardless of the transfer price used for sales by USAco to FORco, the combined income from a foreign sale is $300 per engine [$1,000 final sales price – $600 manufacturing cost – $100 selling expense]. However, transfer prices do affect the allocation of that combined profit between USAco and FORco.

Figure 5.1 Transfer pricing example

At one extreme, a transfer price of $600 would allocate the combined profit of $300 entirely to FORco, as follows.

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At the other extreme, a transfer price of $900 would allocate the combined profit of $300 entirely to USAco, as follows.

For income tax purposes, multinational corporations must allocate their worldwide profits among the various countries in which they operate. The ideal allocation would permit each country to tax an appropriate portion of the taxpayer’s total profit, while avoiding taxation of the same income by more than one country. The mechanism for allocating a multinational’s worldwide profits between its U.S. and foreign affiliates is the transfer price used for intercompany transactions. When tax rates vary across countries, transfer pricing can have a significant effect on the taxpayer’s total tax costs.

For example, the foreign tax credit limitation prevents U.S. companies operating in high-tax foreign jurisdictions from claiming a credit for those excess foreign taxes. These noncreditable foreign taxes increase the worldwide tax rate on foreign earnings above the U.S. corporate rate of 35%. A domestic corporation may be able to avoid these higher foreign taxes by altering its transfer prices so as to shift income out of these high-tax jurisdictions. For example, a U.S. manufacturer may be able to reduce a foreign marketing subsidiary’s share of worldwide profits by using higher prices for controlled inventory sales.

Example 5.2: The facts are the same as in Example 5.1. Assume that the U.S. tax rate is 35% and the applicable foreign tax rate is 45%. Given this rate differential, the USAco group can reduce its worldwide taxes by using higher transfer prices for its controlled sale. For example, if a transfer price of $600 is used for a sale by USAco to FORco, the $300 gross profit is allocated entirely to FORco, and the total tax on that profit equals the foreign tax of $135 [$300 of income × 45% foreign tax rate]. If a transfer price of $900 is used for the controlled sale, the $300 gross profit is allocated entirely to USAco, and the total tax on that profit equals the U.S. tax of $105 [$300 of income × 35% U.S. tax rate].

Transfer pricing also is a relevant issue for U.S. companies with operations in low-tax foreign jurisdictions. In these situations, a U.S. parent corporation has
an incentive to shift income to its low-tax foreign subsidiary by, for example, using lower transfer prices on controlled inventory sales. Although shifting income to a low-tax foreign subsidiary does not permanently avoid the residual U.S. tax on those low-taxed foreign earnings, it does defer that tax until the foreign subsidiary repatriates those earnings through a dividend distribution.

Similarly, transfer pricing is a relevant issue for foreign-owned U.S. companies.

Example 5.3: CANco, a Canadian company, manufactures and sells widgets in the United States. Due to increased widget orders from U.S. customers, CANco decides to form a U.S. distribution subsidiary (“USub”). Although USub does not have any manufacturing functions, USub employs its own administrative and sales staff while using CANco’s unique distribution software to ensure that there are not any distribution problems. In an effort to ensure that USub is financially solvent, USub has payment terms to CANco of six months (USub’s average collection period is one month). If USub’s customers do not pay, USub enjoys the use of CANco’s collection staff.

This example illustrates four intercompany transactions for which USub must pay CANco at arm’s length. First, the purchase of widgets constitutes a purchase of tangible property. Second, the use of the unique distribution software constitutes a transfer of intangible property for which USub must pay a royalty. Third, the generous payment terms constitute a loan on which USub may pay an arm’s length rate of interest. Fourth, the provision of the collection staff constitutes a service for which USub will have to pay an arm’s length amount.

With respect to the transfer pricing practices of foreign-owned U.S. companies, transfer pricing is considered a repatriation method to bring cash back to the foreign company without paying a U.S. withholding tax on dividends. By employing aggressive transfer pricing practices, cash goes back to the foreign company while leaving fewer earnings and profits in the U.S. that would result in a distribution being a dividend that is subject to a withholding tax. Even if the foreign country’s marginal corporate tax rate is higher than the U.S.’s marginal corporate tax rate, the addition of the withholding tax may result in an overall U.S. tax rate that is higher than the foreign country’s tax rate.

This problem may be particularly acute where, for example, the foreign parent’s country does not tax the dividend and the withholding tax is considered an out-of-pocket cash cost.

Example 5.4: CANco is a trading company organized in Canada. Assume the top combined Canadian federal and provincial income tax rate is 40%. CANco owns a U.S. subsidiary (“USub”) that purchases gadgets from CANco for resale in the United States, where the combined federal and state effective tax rate is 38%. In addition to the U.S. combined federal and state income taxes at a rate of 38%, any dividend distributed by USub to CANco will be subject to a 5% withholding tax, resulting in an effective U.S. tax rate
of 41% (i.e., after 38¢ of every dollar of income goes to the IRS an additional 3¢ of the remaining 62¢ dividend is withheld). As a result, by aggressively pricing widgets from CANco to USSub, the parties can save one cent for every dollar not subject to U.S. tax (40¢ compared to 41¢).

§502 TRANSFER PRICING METHODS

.01 Basic Principles

The purpose of Code Sec. 482 is to ensure that taxpayers report and pay tax on their actual share of income arising from controlled transactions. To this end, the Regulations under Code Sec. 482 adopt an arm’s-length or market value standard for evaluating the appropriateness of a transfer price. Under this standard, a taxpayer should realize the same amount of income from a controlled transaction as an uncontrolled party would have realized from a similar transaction under similar circumstances.

To arrive at an arm’s-length result, the taxpayer must select and apply the method that provides the most reliable estimate of an arm’s-length price. Thus, the primary focus in selecting a transfer pricing method is the reliability of the result, not its theoretical accuracy. The reliability of a pricing method is determined by the degree of comparability between the controlled and uncontrolled transactions, as well as the quality of the data and the assumptions used in the analysis. The principal factors to consider in assessing the comparability of controlled and uncontrolled transactions include the following:

- Functions performed—The functional analysis identifies and compares the economically significant activities undertaken. These activities would include, for example, research and development, manufacturing or production, marketing and distribution, transportation and warehousing, and administrative functions. The theory behind this part of the regulations is that a party performing more functions should receive more of the income.

- Contractual terms—Significant contractual terms could affect the results of two transactions. For example, the quantity of items purchased or sold, the form of consideration (paid in local or foreign currency), the scope of any warranties, the rights to updates or modifications, the duration of the contract, the extent of any collateral transactions between the parties, and the extension of any credit or payment terms may have an economic effect on the transaction.

- Risks assumed—This analysis requires a comparison of the significant risks that could affect the prices to be charged. For example, risk associated with the success or failure of research and development activities, finances (such as fluctuations in foreign currency and interest rates), credit and collection, product liability, and market fluctuation.

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2 Reg. §1.482-1(a)(1).
3 Reg. §1.482-1(b)(1).
4 Reg. §1.482-1(c)(1).
5 Reg. §1.482-1(c)(2).
6 Reg. §1.482-1(d)(1).
- Economic conditions and markets—This comparability factor focuses on the economic conditions that could affect the prices to be charged. This includes the similarity of geographic markets, the level of the market (e.g., wholesale or retail), the extent of competition in each market, the economic conditions of the particular industry, and the alternatives realistically available to either party.

- Nature of the property or services transferred in the transaction—As discussed more later in this chapter, the comparability of property sold or services provided is more relevant to the transaction-based methods than the profit-based methods.

Example 5.5: USAco, a U.S. subsidiary of ASIAco, a Japanese parent corporation, purchases televisions from its Japanese parent that USAco markets in the U.S. If it were to use one of the transaction-based methods, USAco must compare prices charged for televisions. However, if the taxpayer chooses a profit-based method, such as the comparable profits method, USAco must merely find companies comparable to itself with respect to the type of functions performed and the risks assumed.

Adjustments must be made for any material differences between the controlled and uncontrolled transactions, assuming the effect of the difference can be ascertained with enough accuracy to improve the reliability of the results.7

As a practical matter, comparable transactions often are not readily available for the types of transactions entered into by affiliates of a vertically integrated multinational corporation. For example, inventory sales between affiliated companies often involve component parts and semifinished goods that are unique and are not sold in public markets. As a consequence, the appropriate arm’s-length price is ambiguous. The only significant exceptions are publicly traded fungible goods such as oil, lumber, and agricultural products, for which information regarding market prices is readily available.

The concept of the arm’s-length range helps taxpayers deal with this uncertainty. Under this provision, a taxpayer may use two or more comparable uncontrolled transactions (of similar comparability and reliability) to establish an arm’s-length range of prices. If the taxpayer’s transfer prices lie within the range, the IRS will not make an adjustment.8 If the taxpayer’s transfer prices lie outside the arm’s-length range, then the IRS will make an adjustment, generally using either the mean or the median of the range as the benchmark price.9 Taxpayers also are allowed, under certain circumstances, to satisfy the arm’s-length requirement by showing that the average result for a multiple-year period is comparable to that of uncontrolled transactions for the same period.10 The use of multiple-statistical techniques, such as restricting the range to those comparable uncontrolled transactions which fall within the 25th and 75th percentiles of the range. Reg. § 1.482-1(e)(3).

Reg. § 1.482-1(f)(2)(iii).

7 Reg. § 1.482-1(d)(2).
8 Reg. § 1.482-1(e)(1) and (e)(2)(i). All comparable uncontrolled transactions are included in the range if adjustments can be made for all of the material differences between the controlled and uncontrolled transactions. If adjustments cannot be made for all material differences, then the range is limited by statistical techniques, such as restricting the range to those comparable uncontrolled transactions which fall within the 25th and 75th percentiles of the range. Reg. § 1.482-1(e)(2)(iii).
9 Reg. § 1.482-1(e)(3).
10 Reg. § 1.482-1(f)(2)(iii).
year data helps reduce the effects of short-term variations in prices, such as the
effects of an industry business cycle, that are unrelated to transfer pricing.

.02 Loans and Advances

Controlled entities generally must charge each other an arm’s-length rate of
interest on any intercompany loans or advances. There is an exception, however,
for intercompany trade receivables, which are debts that arise in the
ordinary course of business and are not evidenced by a written agreement
requiring the payment of interest. If the controlled borrower is located outside
the United States, it is not necessary to charge interest on an intercompany trade
receivable until the first day of the fourth month following the month in which
the receivable arises. If the controlled borrower is located within the United
States, the interest-free period extends to the first day of the third month
following the month in which the receivable arises. This exception reflects the
common business practice of not charging interest on trade receivables.

Example 5.6: USAco, a domestic corporation, owns 100% of ASIAco, a
foreign corporation. On November 1, ASIAco purchases $1 million of inven-
tory on account from USAco. The $1 million debt, on which ASIAco pays no
interest, is still outstanding on December 31, which is the end of USAco’s
taxable year. Since the $1 million intercompany trade receivable was out-
standing for only two months, USAco does not have to recognize any
interest income.

Longer interest-free periods are possible if the controlled lender ordinarily allows
unrelated parties a longer interest-free period, or if a controlled borrower
purchases the goods for resale in a foreign country and the average collection
period for its sales is longer than the interest-free period.

Intercompany debt other than a trade receivable generally must bear an
arm’s-length interest charge. To determine the arm’s-length rate, the taxpayer
must consider all relevant factors, including the amount and duration of the loan,
the security involved, the credit standing of the borrower, and the interest rate
prevailing at the situs of the lender for comparable loans between uncontrolled
parties. If an arm’s-length rate is not readily determinable, the taxpayer can still
protect itself against an IRS adjustment by satisfying the requirements of a safe-
harbor provision. Under this safe harbor, an interest rate is deemed to be an
arm’s-length rate if it is between 100% and 130% of the applicable federal rate.
The applicable federal rate is the average interest rate (redetermined monthly) on
obligations of the federal government with maturities similar to the term on the
intercompany loan.

Example 5.7: USAco, a domestic corporation, owns 100% of EURco, a
foreign corporation. During the current year, USAco borrows $1 million
The rate of interest on the loan entered into with the unrelated borrower. Thus, the arm’s-length rate on such pass-through loans is assumed to be equal to the rate paid by the controlled lender on the original loan, increased by any associated borrowing costs, unless the taxpayer can establish that a different rate is more appropriate under the general rules.

Example 5.8: USAco, a domestic corporation, owns 100% of GERco, a German corporation. During the current year, USAco borrows $10 million from a German bank at a 10% rate, and then relends the funds to GERco. The arm’s-length rate on the intercompany loan is deemed to be equal to 10% plus any borrowing costs incurred by USAco in securing the original loan. A rate other than 10% also can be used if USAco can establish that such a rate is arm’s length, taking into account all of the relevant facts and circumstances.

.03 Performance of Services

Currently existing final regulations. An arm’s-length fee generally must be charged if one controlled entity performs services for the benefit of, or on behalf of, another controlled entity. However, under a safe-harbor provision, a charge equal to the direct and indirect costs incurred by the controlled entity in providing the service is deemed to be an arm’s-length charge. This safe harbor reflects the reality that intercompany services sometimes are provided for reasons of convenience, rather than profit.

Example 5.9: USAco, a domestic corporation, produces food products at its U.S. plant for sale domestically and abroad. USAco markets its products abroad through FORco, a wholly owned foreign marketing subsidiary. During the current year, USAco performs some payroll services for FORco as a convenience for FORco’s management. The costs associated with these services include $10,000 of salaries plus an overhead allocation of $3,000. Under

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24 Reg. § 1.482-2(b)(1).
25 Reg. § 1.482-2(b)(3)–(b)(5).
the safe-harbor rule, $13,000 is deemed to be an arm's-length charge for these services. A charge other than $13,000 also is allowable if USAco can establish that such a charge is arm's length, taking into account all of the relevant facts and circumstances.

The safe harbor is not available if the services are an integral part of the business activity of either the service provider or the service recipient. For example, if in Example 5.6, the domestic parent was in the business of providing payroll services, it would have to charge its affiliate the same amount that it charges its unrelated customers for payroll services. A service is an integral part of the business activities of the service provider or recipient in the following situations:

(i) the service provider or recipient is engaged in the business of rendering similar services to unrelated parties,

(ii) a principal activity of the service provider is providing such services to related parties,

(iii) the service provider is peculiarly capable of rendering the service and such services are a principal element in the operations of the recipient, or

(iv) the recipient receives a substantial amount of services from affiliates during the year.

Another exception applies to services that are ancillary and subsidiary to a controlled transfer of tangible or intangible property. Consistent with the common business practice of including installation and start-up services in the associated sale or rental price, it is not necessary to provide a separate charge for ancillary and subsidiary services.

Example 5.10: USAco, a domestic corporation, owns 100% of AFRlco, a foreign corporation. During the current year, USAco sells some manufacturing equipment to AFRlco. An engineer employed by USAco travels abroad to install the equipment. Although AFRlco must pay an arm's-length price for the equipment, a separate charge need not be made for the installation services. On the other hand, if the engineer also supervises AFRlco's manufacturing operation after the equipment has been effectively integrated into AFRlco's manufacturing operations, then AFRlco must pay USAco for these follow-on services since they are not ancillary and subsidiary to the sale.

An exception also applies to services performed by a parent corporation for one of its subsidiaries, where the parent's services merely duplicate those performed by the subsidiary. The parent need not charge the subsidiary for these services if they are undertaken for the parent's benefit in overseeing its investment rather than for the subsidiary's benefit.

Example 5.11: The financial staff of a foreign subsidiary prepares a report regarding the subsidiary's financing needs. An executive from the

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26 Reg. §1.482-2(b)(7).
27 Reg. §1.482-2(b)(7)(i)-(iv).
28 Reg. §1.482-2(b)(6).
29 Reg. §1.482-2(b)(7)(ii).
U.S. parent corporation’s home office reviews the report. The parent need not charge the subsidiary for this service because it merely duplicates those performed by the subsidiary itself. On the other hand, if the foreign subsidiary did not have a financial staff, and the home office executive performed the original analysis rather than merely reviewing it, a charge would have to be made.\textsuperscript{30}

Proposed regulations. The IRS issued proposed regulations for intercompany services on September 5, 2003. As proposed, these regulations do not have the effect of law, but are indicative of the IRS’s position. These proposed regulations contain several changes from the old final regulations.

First, the proposed regulations eliminate the safe harbor charge equal to the direct and indirect costs for non-integral services. Instead, the regulations propose the simplified cost-based method (“SCBM”)\textsuperscript{31} for non-integral services, such as routine administrative services. The SCBM applies when the taxpayer charges a markup of 10\% or less. Under the SCBM, the IRS cannot make an adjustment unless the arm’s length markup exceeds 6\%. More specifically, if the taxpayer has not charged a markup, the IRS must determine that the arm’s length markup is at least 6\% to make an adjustment. Furthermore, based on a sliding scale, a taxpayer’s markup of 9\% is not subject to adjustment unless the IRS determines that the arm’s length markup is 10\% or greater.

Unlike the final regulations, the proposed regulations also provide counterparts to the traditional methods for determining arm’s-length pricing for services. These include the comparable uncontrolled services price method, the gross services margin method, the cost of services plus method, the comparable profits method, and the profit split methods.\textsuperscript{32}

.04 Use of Tangible Property

Intercompany leases of tangible property generally must bear an arm’s-length rental charge.\textsuperscript{33} The arm’s-length rental is the amount that would have been charged for the use of the same or similar property in a transaction between unrelated parties under similar circumstances. All relevant factors must be considered in determining the arm’s-length rental, including the period and location of the property’s use, the owner’s investment in the property, the owner’s maintenance expenses, and the type and condition of the property.\textsuperscript{34}

A special rule applies if the controlled lessor first leased the property from an unrelated person and then subleased it to the controlled lessee. In such cases, the controlled lessor is treated as a mere conduit for the lease it entered into with the unrelated lessor. Thus, the arm’s-length rental for such pass-through leases is deemed to be equal to the rental paid by the controlled lessor on the original lease, increased by any associated rental costs (e.g., maintenance, repairs, utilities, and managerial expenses).\textsuperscript{35} This rule does not apply if either the controlled

\textsuperscript{30} Compare Reg. §1.482-2(b)(2)(ii), Examples 1 and 2.

\textsuperscript{31} Prop. Reg. §1.482-9(f).

\textsuperscript{32} Prop. Reg. §1.482-9(b)-(g).

\textsuperscript{33} Reg. §1.482-2(c)(1).

\textsuperscript{34} Reg. §1.482-2(c)(2)(i).

\textsuperscript{35} Reg. §1.482-2(c)(2)(iii)(A).
lessor or controlled lessee is regularly engaged in the business of leasing the type of property in question to unrelated persons, or if the taxpayer establishes a more appropriate rental rate under the general rules.36

.05 Transfers of Tangible Property

Introduction. There are five specified methods for estimating an arm’s-length charge for transfers of tangible property:

(i) the comparable uncontrolled price method,

(ii) the resale price method,

(iii) the cost plus method,

(iv) the comparable profits method, and

(v) the profit split method.37

The taxpayer must select and apply the method that provides the most reliable estimate of an arm’s-length price.38 In addition to the five specified methods, the taxpayer also has the option of using an unspecified method. However, an unspecified method can be used only if it provides the most reliable estimate of an arm’s-length price.39

When the transfer involves tangible property with embedded intangibles, such as a controlled sale of inventory where the related seller attaches its trademark to the goods, it is not necessary to develop separate arm’s-length charges for the intangible if the purchaser does not acquire the right to exploit the intangible other than in connection with the resale of the property. However, the embedded intangible must be taken into account for purposes of determining the arm’s-length price for the sale of the related tangible property.40

Comparable uncontrolled price method. Under the comparable uncontrolled price method, the arm’s-length price is the price charged for comparable goods in transactions between uncontrolled parties, adjusted for any material differences that exist between the controlled and uncontrolled transactions.41 The comparable uncontrolled price method ordinarily is the most reliable method for estimating an arm’s-length price if there are only minor differences between the controlled and uncontrolled transactions for which appropriate adjustments can be made.42

Example 5.12: USAco, a domestic corporation, owns 100% of MEXco, a Mexican corporation. USAco manufactures telecommunications equipment at a cost of $500 per unit and sells the equipment to unrelated foreign distributors at a price of $750 per unit. USAco also sells the equipment to MEXco, which then resells the goods to unrelated foreign customers for $850 each. The conditions of USAco’s sales to MEXco are essentially equivalent to those of the sales made to unrelated foreign distributors. Because informa-

37 Reg. § 1.882-3(a).
38 Reg. § 1.882-4(c)(1).
39 Reg. § 1.882-3(e)(1).
40 Reg. § 1.882-3(f).
41 Reg. § 1.882-3(b)(1) and (b)(2)(ii)(B).
42 Reg. § 1.882-3(b)(2)(ii)(A).
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In assessing the comparability of controlled and uncontrolled transactions for purposes of the comparable uncontrolled price method, the most important factor is product similarity. Other significant factors include the similarity of contractual terms and economic conditions. Because information regarding comparable uncontrolled transactions is usually not available, the comparable uncontrolled price method is usually difficult to apply in practice.

Resale price method. The type of transaction envisioned by the resale price method is a controlled sale of finished goods followed by the related distributor's resale of the goods to unrelated customers. Under this method, the arm's-length price is the resale price charged by the related distributor, reduced by the arm's-length gross profit margin for such resales, and adjusted for any material differences that exist between the controlled and uncontrolled transactions. The gross profit margin realized by independent distributors (or even the related distributor) on similar uncontrolled sales provides an estimate of the arm's-length gross profit, which is expressed as a percentage of the resale price.

Example 5.13: USAco, a domestic corporation, owns 100% of CANco, a Canadian corporation. USAco manufactures medical equipment at a cost of $1,000 per unit and sells the equipment to CANco, which resells the goods (without any further processing) to unrelated foreign customers for $1,500 each (see Figure 5.2). Independent foreign distributors typically earn commissions of 10% (expressed as a percentage of the resale price) on the purchase and resale of products comparable to those produced by USAco. Under the resale price method, the estimate of the arm's-length price is $1,350 [$1,500 - (10% x $1,500)].

43 Reg. § 1.482-3(b)(2)(ii)(A).
44 Reg. § 1.482-3(c)(1).
45 Reg. § 1.482-3(c)(2) and (c)(3)(ii)(C).
In assessing the comparability of controlled and uncontrolled transactions for purposes of the resale price method, product similarity is less important than under the comparable uncontrolled price method, while the similarity of the functions performed, risks borne, and contractual terms agreed to is relatively more important.46 Consistency between the accounting methods used to compute the gross profit for the controlled and uncontrolled transactions also is important.47

Cost plus method. The type of controlled transaction envisioned by the cost plus method is the manufacture, assembly, or other production of goods that are sold to related parties.48 Under the cost plus method, the arm’s-length price is the manufacturing cost incurred by the related manufacturer, increased by the arm’s-

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46 Reg. §1.482-3(c)(3)(ii)(A) and (B).
47 Reg. §1.482-3(c)(3)(iii)(B).
48 Reg. §1.482-3(d)(1).
length gross profit markup for such manufacturers, and adjusted for any material differences that exist between the controlled and uncontrolled transactions. The gross profit realized by independent manufacturers (or even the related manufacturer) on similar uncontrolled sales provides an estimate of the arm's-length gross profit markup, which is expressed as a percentage of the manufacturing costs.\footnote{Reg. § 1.482-3(d)(2) and (d)(3)(ii)(C).}

\textbf{Example 5.14:} USAco, a domestic corporation, owns 100\% of FORco, a foreign corporation. FORco manufactures power tools at a cost of $60 each and sells them to USAco. USAco attaches its trade name to the power tools (which has a significant effect on their resale price) and resells them to unrelated customers in the United States for $100 each (see Figure 5.3). Independent foreign manufacturers producing similar power tools typically earn a gross profit markup of 20\%. Under the cost plus method, the estimate of the arm's-length price is $72 \left[\$60 + (20\% \times \$60)\right]$. 
As with the resale price method, in assessing the comparability of controlled and uncontrolled transactions for purposes of the cost plus method, product similarity is less important than under the comparable uncontrolled price method, while the similarity of the functions performed, risks borne, and contractual terms agreed to is relatively more important. Consistency between the accounting methods used to compute the gross profit markup for the controlled and uncontrolled transactions also is important.

Comparable profits method. The comparable profits method looks to the profits of uncontrolled entities, rather than the prices used in uncontrolled transactions, to determine an arm's-length allocation of profit between two related corporations. Under this method, the profitability of comparable uncontrolled entities is used as a benchmark for determining an arm's-length net profit for one of the controlled parties (the "tested party"), and then a transfer price is established which leaves the tested party with that amount of net profit.

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50 Reg. § 1.482-3(d)(3)(ii)(A) and (B).
51 Reg. § 1.482-3(d)(3)(iii)(B).
52 Reg. § 1.482-5(b)(1).
The methodology for developing an arm’s-length profit involves the following six steps:

1. **Determine the tested party**—The tested party should be the participant in the controlled transactions for which the most reliable data regarding comparable uncontrolled parties can be located. This is likely to be the least complex of the controlled parties, and the controlled party that does not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.53

2. **Obtain financial data regarding comparable uncontrolled parties**—The key factors in assessing the comparability of the tested party to uncontrolled parties are the resources employed and the risks assumed. Because resources and risks usually are directly related to functions performed, it also is important to consider the functions performed in determining the degree of comparability between the tested party and an uncontrolled party.54 Another important factor is the consistency between the accounting methods used by the controlled and uncontrolled parties to compute their operating profits.55 Adjustments must be made for any differences between the tested party and the comparable uncontrolled parties that would materially affect the profitability measures used.56

3. **Select a profit level indicator**—Examples of the profitability measures that can be used include the ratio of operating profit to operating assets, the ratio of operating profit to sales, and the ratio of gross profit to operating expenses. To enhance the reliability of a profitability measure, the taxpayer should perform a multiyear analysis which generally should encompass at least the taxable year under review and the two preceding years.57

4. **Develop an arm’s-length range of comparable operating profits**—To construct an arm’s-length range of comparable operating profits, the selected profitability measure (e.g., the ratio of operating profit to operating assets) is applied to the tested party’s most narrowly identifiable business activity for which data incorporating the controlled transaction is available (e.g., the operating assets used in the manufacture and sale of inventory).58

5. **Determine if an adjustment must be made**—An adjustment is required if the tested party’s reported profit lies outside the arm’s-length range of comparable operating profits developed in step 4.59

6. **Adjust the transfer price used for the controlled transaction**—If the tested party’s reported profit lies outside the arm’s-length range, an adjustment is made equal to the difference between the tested party’s re-
ported profit and the benchmark arm’s-length profit, such as the mean or the median of the arm’s-length range of comparable operating profits.

Example 5.15: EURco, a foreign corporation, owns 100% of USACo, a domestic corporation. EURco manufactures consumer products for worldwide distribution. USACo imports EURco’s finished goods for resale in the United States. USACo’s average financial results for the last three years are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$50 million</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>&lt;$40 million&gt;</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>&lt;$9 million&gt;</td>
</tr>
<tr>
<td>Operating profit</td>
<td>$1 million</td>
</tr>
</tbody>
</table>

USACo is selected as the tested party because it engages in activities that are less complex than those of EURco. An analysis of five comparable uncontrolled U.S. distributors indicates that the ratio of operating profits to sales is the most appropriate profitability measure. After adjustments have been made to account for material differences between USACo and the uncontrolled distributors, the average ratio of operating profit to sales for each uncontrolled distributor is as follows: 3%, 4%, 5%, 5%, and 7%.

Applying these percentages to USACo’s sales of $50 million yields the following arm’s-length range of comparable operating profits: $1.5 million, $2 million, $2.5 million, $2.5 million, and $3.5 million. Therefore, the interquartile range of comparable operating profits is used for purposes of testing USACo’s profits. This range includes $2 million, $2.5 million, and $2.5 million.

Because USACo’s reported operating profit of $1 million lies outside the arm’s-length range, an adjustment is required. The median of the interquartile range of comparable operating profits (i.e., $2.5 million) is determined to be the arm’s-length profit for USACo. Therefore, the transfer prices that USACo pays EURco for its inventory are reduced by $1.5 million, which equals the difference between USACo’s reported profit of $1 million and the arm’s-length profit of $2.5 million. This adjustment increases USACo’s U.S. taxable income by $1.5 million per year, with a corresponding decrease in EURco’s taxable income.

Profit split method. The profit split method is the most complicated of the specified pricing methods for transfers of tangible property, and therefore is difficult to apply in practice. The profit split method evaluates whether the allocation of the combined operating profit attributable to a controlled transaction is arm’s length by reference to the relative value of each controlled taxpayer’s contribution to that combined profit. The relative value of each

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60 Reg. §1.482-5(b)(1).
61 Reg. §1.482-1(e)(3).
62 This example is based on Reg. §1.482-5(e), Example 2.
63 Reg. §1.482-6(a).
the controlled taxpayer’s contribution is determined using either the comparable profit split method or the residual profit split method.

Under the comparable profit split method, the allocation of the combined operating profit between two controlled taxpayers is based on how uncontrolled taxpayers engaged in similar activities under similar circumstances allocate their joint profits. Under the residual profit split method, the comparable profits method is used to estimate and allocate an arm’s-length profit for the routine contributions made by each controlled taxpayer. Routine contributions ordinarily include contributions of tangible property and services. The residual profit not allocated on the basis of routine functions is then allocated between the two controlled taxpayers on the basis of the relative value of the intangible property contributed by each party.

Ceiling on transfer price for imported goods. There is a statutory ceiling on the transfer prices used for property imported into the United States in a transaction between controlled parties. Examples of such transactions include a U.S. parent corporation purchasing goods from a foreign manufacturing subsidiary, or a U.S. marketing subsidiary purchasing goods from its foreign parent corporation. In such cases, the transfer price used by the controlled purchaser for income tax purposes (which becomes the controlled purchaser’s cost basis for computing the gain on resale) cannot exceed the value amount taken into account for purposes of determining custom duties. This ceiling is designed to prevent taxpayers from simultaneously avoiding U.S. custom duties and U.S. income taxes by using a low transfer price for custom purposes and a high price for income tax purposes.

.06 Transfer or Use of Intangibles

Introduction. For transfer pricing purposes, an “intangible” includes any of the following items:

(i) patents, inventions, formulae, processes, designs, patterns, or know-how,
(ii) copyrights and literary, musical, or artistic compositions,
(iii) trademarks, trade names, or brand names,
(iv) franchises, licenses, or contracts,
(v) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data, and
(vi) other similar items.

The owner of an intangible for tax purposes ordinarily is the taxpayer who owns the legally protected right to exploit that intangible. However, if an intangible is not legally protected, it may be unclear which of the controlled parties is the owner of the intangible. In such cases, the controlled party that bore the largest

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64 Reg. § 1.482-6(c)(2).
65 Reg. § 1.482-6(c)(3).
66 Code Sec. 1059A.
67 Reg. § 1.482-4(b).
portion of the direct and indirect costs of developing the intangible ordinarily is treated as the owner for tax purposes.69

There are three specified methods for estimating an arm’s-length charge for transfers of intangibles:

(i) the comparable uncontrolled transaction method,
(ii) the comparable profits method, and
(iii) the profit split method.70

The taxpayer must select and apply the method which provides the most reliable estimate of an arm’s-length price.71 In addition to the three specified methods, the taxpayer also has the option of using an unspecified method. However, an unspecified method can be used only if it provides the most reliable estimate of an arm’s-length price.72

Comparable uncontrolled transaction method. The comparable uncontrolled transaction method is equivalent to the comparable uncontrolled price method used for transfers of tangible property. Thus, under the comparable uncontrolled transaction method, the arm’s-length charge for the transfer of an intangible is the amount charged for comparable intangibles in transactions between uncontrolled parties, adjusted for any material differences that exist between the controlled and uncontrolled transactions.73 In order for the intangibles involved in the uncontrolled transaction to be considered comparable to the intangible involved in the controlled transaction, both intangibles must be used in connection with similar products or processes within the same general industry or market and must have similar profit potential.74 The comparable uncontrolled transaction method ordinarily is the most reliable method for estimating an arm’s-length price if there are only minor differences between the controlled and uncontrolled transactions for which appropriate adjustments can be made.75 Because information regarding comparable uncontrolled transactions is usually not available regarding intangible assets such as patents and trademarks, the comparable uncontrolled transaction method usually is difficult to apply in practice.

Comparable profits method. The same comparable profits method used to determine arm’s-length prices for transfers of tangible property also can be used to determine arm’s-length sales prices or royalty rates for transfers of intangible property.

Example 5.16: 76 USACo, a domestic corporation, owns 100% of the stock of ASIAco, a foreign corporation. ASIAco manufactures one of USACo’s patented technologies under a licensing agreement. ASIAco then sells its entire output of this product at an arm’s-length price to USACo, which
markets the product in the United States. ASIAco’s average financial results for the last three years are as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$20 million</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>&lt;$12 million&gt;</td>
</tr>
<tr>
<td>Royalty paid to USAco (5% of sales)</td>
<td>&lt;$1 million&gt;</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>&lt;$2 million&gt;</td>
</tr>
<tr>
<td>Operating profit</td>
<td>$5 million</td>
</tr>
<tr>
<td>Operating assets</td>
<td>$25 million</td>
</tr>
</tbody>
</table>

ASIAco is selected as the tested party because it engages in relatively routine manufacturing activities, whereas USAco engages in a variety of complex activities using unique and valuable intangibles. Because ASIAco is engaged in manufacturing, the ratio of operating profits to operating assets is the most appropriate profitability measure. After adjustments have been made to account for material differences between ASIAco and a sample of five uncontrolled foreign manufacturers for which data is available, the average ratio of operating profit to operating assets for each uncontrolled distributor is as follows: 8%, 10%, 15%, 15%, and 18%.

Applying these percentages to ASIAco’s operating assets yields the following arm’s-length range of comparable operating profits for ASIAco: $2 million, $2.5 million, $3.75 million, $3.75 million, and $4.5 million. Therefore, the interquartile range of comparable operating profits is used for purposes of testing ASIAco’s profits. This range includes $2.5 million, $3.75 million, and $3.75 million.

Because ASIAco’s reported operating profit of $5 million lies outside the arm’s-length range, an adjustment is required. The median of the interquartile range of comparable operating profits (i.e., $3.75 million) is determined to be the arm’s-length profit for ASIAco. Therefore, the royalty that ASIAco pays USAco is increased by $1.25 million, which equals the difference between ASIAco’s reported profit of $5 million and the arm’s-length profit of $3.75 million. This adjustment increases USAco’s U.S. taxable income by $1.25 million per year, with a corresponding decrease in ASIAco’s taxable income.

Profit split method. See the discussion of the profit split method under “Transfers of Tangible Property,” above.

Commensurate with income requirement. Many U.S. companies have moved operations to foreign countries offering low-cost labor, low tax rates, less government regulation, and new markets. These companies typically have manufacturing and marketing intangibles that they can transfer to their foreign subsidiaries. For example, a foreign manufacturing subsidiary might manufacture a good under a license from its domestic parent corporation and then sell its entire output to the parent at a markup. If the foreign subsidiary is located in a low-tax foreign jurisdiction, the domestic parent will defer U.S. taxes to the extent the intercompany royalty rate understates the economic value of the
intangible. It is often very difficult to determine the appropriate arm's-length royalty rate because information regarding comparable uncontrolled transactions is usually not available regarding intangible assets such as patents and trademarks.

In response to these problems, in 1986 Congress enacted a requirement that transfer prices for sales or licenses of intangibles must be "commensurate with the income attributable to the intangible."77 In other words, transfer prices must reflect the actual profit experience realized subsequent to the outbound transfer. To meet this requirement, the original sales price or royalty rate must be adjusted annually to reflect any unanticipated changes in the income actually generated by the intangible.78 For example, if a new patent leads to a product that turns out to be far more successful than was expected at the time the patent was licensed, the taxpayer must increase the intercompany royalty payments to reflect that unanticipated profitability. A determination in an earlier year that the royalty was arm's length does not preclude the IRS from making an adjustment in a subsequent year.79

The need to make periodic adjustments places a significant administrative burden on taxpayers. This burden is mitigated somewhat by the following exceptions:

(i) De minimis exception—Periodic adjustments are not required if the total profits actually realized by the controlled transferee from the use of the intangible are between 80% and 120% of the profits that were foreseeable when the agreement was entered into, and there have been no substantial changes in the functions performed by the transferee since the agreement was executed, except for changes required by unforeseeable events. Other requirements include the existence of a written royalty agreement, and the preparation of contemporaneous supporting documentation.80 In addition, if the requirements of the de minimis exception are met for each of five consecutive taxable years, then no further periodic adjustments are required under any conditions.81

(ii) Extraordinary event exception—Even if the total profits actually realized by the controlled transferee from the use of the intangible are less than 80% or more than 120% of the profits that were foreseeable when the agreement was entered into, the taxpayer need not make periodic adjustments if the unexpected variation in profits is due to extraordinary events that could not have been reasonably anticipated and are beyond the taxpayer's control. In order to use this exception, all of the requirements of the de minimis exception, other than the 80%-120% test, also must be met.82

77 Code Sec. 482.
78 Reg. § 1.482-4(f)(2)(i).
79 Reg. § 1.482-4(f)(2)(i).
80 Reg. § 1.482-4(f)(2)(ii)(C). A slightly different set of requirements applies if the arm's-length amount was determined under the comparable uncontrolled transaction method. Reg. § 1.482-4(f)(2)(ii)(B).
82 Reg. § 1.482-4(f)(2)(ii)(D).
(iii) **Same intangible exception**—No periodic adjustments are required if the following requirements are met: (i) the same intangible was transferred to an uncontrolled taxpayer under circumstances similar to those of the controlled transaction, (ii) the uncontrolled transaction serves as the basis for the application of the comparable uncontrolled transaction method, and (iii) an arm’s-length charge is made in the first taxable year of the transfer.83

**Cost-sharing arrangements.** One way for controlled parties to avoid the administrative burden and uncertainties associated with transfer pricing for intangibles is to enter into a cost-sharing arrangement. For example, a U.S. parent corporation and a foreign subsidiary may agree to equally share the costs of developing a new product. Under such an agreement, the parent might own the rights to manufacture and market the new product in the United States, while the subsidiary might own the rights to manufacture and market the new product abroad. The advantage of a cost-sharing arrangement is that the foreign subsidiary’s ownership of the foreign rights to the intangible negates the need to have that subsidiary pay a royalty to its U.S. parent: A bona fide cost-sharing arrangement must allocate research and development costs in proportion to the profits earned by each controlled party from the intangible, and each controlled party must bear a portion of the costs incurred at each stage of the development of both successful and unsuccessful intangibles.84

### .07 Correlative Adjustments and Setoffs

When the IRS increases the taxable income of a related party through a transfer pricing adjustment, it will also reduce the income of the related party for U.S. purposes.

**Example 5.17:** USAco sells machinery to FORco, its foreign subsidiary. The IRS makes a transfer pricing adjustment, increasing the income of USAco on the sale of machinery by $1 million. The IRS will also decrease the income of FORco by $1 million, which will reduce FORco’s earnings and profits and affect the foreign tax credit computation. Accordingly, the IRS may permit USAco to establish an account receivable so that FORco’s payment of cash in the amount of the adjustment will not result in additional income.

The IRS will generally permit a taxpayer to offset a negative transfer pricing adjustment with a favorable transfer pricing adjustment provided that the adjustments are for the same two related parties.

**Example 5.18:** USAco sells machinery to FORco, its foreign subsidiary. The IRS makes a transfer pricing adjustment, increasing the income of USAco on the sale of machinery by $1 million. If the IRS also determines that USAco should have paid FORco an additional $600,000 for services, the adjustments are offset for a net adjustment of $400,000. If, however, the IRS makes the adjustment for USAco’s sales of machinery to FORco and a

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84 Reg. § 1.482-7.
negative transfer pricing adjustment for the services received from ASIAco (another of USAco's foreign subsidiaries), USAco would not be able to offset the adjustments.

§503 INFORMATION REPORTING REQUIREMENTS

In order to effectively audit the transfer prices used by a U.S. subsidiary of a foreign corporation, the IRS often must examine the books and records of the foreign parent corporation. Historically, foreign parties have resisted making their records available to the IRS or have not maintained records sufficient to determine arm's-length transfer prices. In response, Congress enacted the requirement that each year certain reporting corporations must file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, and maintain certain books and records.\(^{85}\) A domestic corporation is a reporting corporation if, at any time during the taxable year, 25% or more of its stock, by vote or value, is owned directly or indirectly by one foreign person. A foreign corporation is a reporting corporation if, at any time during the taxable year, it is engaged in a U.S. trade or business, and 25% or more of its stock, by vote or value, is owned directly or indirectly by one foreign person.\(^{86}\) In filing a Form 5472, the reporting corporation must provide information regarding its foreign shareholders, certain other related parties, and the dollar amounts of transactions that it entered into during the year with foreign related parties.\(^{87}\) A separate Form 5472 is filed for each foreign or domestic related party with which the reporting corporation engaged in reportable transactions during the year.\(^{88}\) The practical importance of Form 5472 is that the IRS often uses this form as a starting point for conducting a transfer pricing examination.\(^{89}\) (Form 5472 is reproduced in the appendix to Chapter 13.)

In addition to filing Form 5472, a reporting corporation also must maintain permanent books and records sufficient to establish the correctness of the reporting corporation's U.S. tax liability, with an emphasis on transactions with related parties.\(^{90}\) Certain reporting corporations are exempted from these special record maintenance requirements, but still must file Form 5472. These include reporting corporations whose U.S. gross receipts are less than $10 million,\(^{91}\) and reporting corporations whose annual payments to and from foreign related persons with respect to related party transactions are not more than $5 million and are less than 10% of the reporting corporation's U.S. gross income.\(^{92}\) Any reporting corporation that fails to either file Form 5472 or maintain the requisite records may be subject to an annual penalty of $10,000.\(^{93}\)

Information reporting also is required with respect to the foreign subsidiaries of domestic corporations.\(^{94}\) Specifically, each year a U.S. person who owns

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\(^{85}\) See generally, Code Secs. 6038A and 6038C.

\(^{86}\) Reg. §1.6038A-1(c).

\(^{87}\) Reg. §1.6038A-2(b).

\(^{88}\) Reg. §1.6038A-2(a).

\(^{89}\) See Internal Revenue Manual, International Audit Guidelines Handbook, April 1, 2002, 4.61.3.

\(^{90}\) Reg. §1.6038A-3(a)(1).

\(^{91}\) Reg. §1.6038A-1(d).

\(^{92}\) Reg. §1.6038A-1(f).

\(^{93}\) Reg. §1.6038A-4(e).

\(^{94}\) See generally, Code Sec. 6038.
more than 50% or more of the stock, by vote or value, of a foreign corporation must file a Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. In the Form 5471, the U.S. shareholder must provide a wide variety of information regarding the controlled foreign corporation, including the dollar amounts of transactions it entered into with related parties. Any U.S. person who fails to furnish the required information may be subject to an annual penalty of $10,000, as well as a reduction in the taxpayer’s foreign tax credit. As with Form 5472, the practical importance of Form 5471 is that the IRS often uses this form as a starting point for conducting a transfer pricing examination. (Form 5471 is reproduced in the appendix to Chapter 6.)

504 TRANSACTIONAL AND NET ADJUSTMENT PENALTIES

In an attempt to promote more voluntary compliance with the arm’s-length standard, Congress has enacted two special transfer pricing penalties: the transactional penalty and the net adjustment penalty. Both penalties equal 20% of the tax underpayment related to a transfer pricing adjustment made by the IRS. The transactional penalty applies if the transfer price used by the taxpayer is 200% or more (or 50% or less) of the amount determined under Code Sec. 482 to be the correct amount. The net adjustment penalty applies if the net increase in taxable income for a taxable year as a result of Code Sec. 482 adjustments exceeds the lesser of $5 million or 10% of the taxpayer’s gross receipts. Both penalties increase to 40% of the related tax underpayment if the transfer price used by the taxpayer is 400% or more (or 25% or less) of the amount determined under Code Sec. 482 to be the correct amount, or if the net adjustment to taxable income exceeds the lesser of $20 million or 20% of the taxpayer’s gross receipts.

The transactional and net adjustment penalties apply automatically whenever an IRS adjustment exceeds the numerical thresholds. The only way to avoid the penalty in such cases is to satisfy certain safe-harbor requirements. In the case of the transactional penalty, the penalty is waived only if the taxpayer can demonstrate that it had reasonable cause and acted in good faith. In the case of the net adjustment penalty, the reasonable cause and good faith requirements can be met only if the taxpayer can demonstrate, through contemporaneous documentation provided to the IRS within 30 days of a request, that it acted reasonably in selecting and applying a transfer pricing method. These added requirements for avoiding the net adjustment penalty are designed to force taxpayers to develop and have waiting for the IRS all of the documentation that the IRS ordinarily would need to review in a transfer pricing examination. In addition to providing protection against the transfer pricing penalty, the documentation may also persuade the IRS that a transfer pricing adjustment is not

95 Reg. § 1.6038-2(a) and (b).
96 Reg. § 1.6038-2(f).
97 Code Sec. 6038(b) and (c).
99 Code Sec. 6662(a) and (b)(3).
100 Code Sec. 6662(e)(1)(B)(i) and (e)(3)(A).
101 Code Sec. 6662(e)(1)(B)(ii) and (e)(3)(A).
102 Code Sec. 6662(h).
103 Reg. § 1.6662-6(b)(3) and Reg. § 1.6664-4(a).
104 Code Sec. 6662(e)(3)(B)(ii). Documentation is considered contemporaneous if it is in existence at the time the tax return is filed. Reg. § 1.6662-6(d)(2)(ii)(A).
necessary. The IRS's Large and Mid-Size Business Division ("LMSB") has mandated that all LMSB agents should request documentation during audits.\textsuperscript{106}

A taxpayer cannot reasonably conclude that a specified method it selected provided the most reliable measure of an arm's-length result unless it has made a reasonable effort to evaluate the potential application of the other specified methods.\textsuperscript{107} If the taxpayer used an unspecified method, the taxpayer must demonstrate that none of the specified methods would provide a result that clearly reflected income, and that the unspecified method is likely to clearly reflect income.\textsuperscript{108}

\section{.01 Preparing Transfer Pricing Documentation}

The principal supporting documents that a taxpayer normally must include in its contemporaneous documentation are as follows:

(i) an overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property and services,

(ii) a description of the organizational structure (including an organization chart) covering all related parties engaged in potentially relevant transactions,

(iii) any documentation explicitly required by the Regulations under Code Sec. 482,

(iv) a description of the pricing method selected and an explanation of why that method was selected,

(v) a description of the alternative methods that were considered and an explanation of why they were not selected,

(vi) a description of the controlled transactions and any internal data used to analyze those transactions,

(vii) a description of the comparables used, how comparability was evaluated, and what adjustments were made,

(viii) an explanation of the economic analyses and projections relied upon in developing the pricing method, and

(ix) a general index of the principal and background documents along with a description of the recordkeeping system used for cataloging and accessing those documents.\textsuperscript{109}

\section{.02 Information Gathering}

The information gathering stage is usually the most time-consuming aspect of preparing transfer pricing documentation. The taxpayer will typically have to interview operational personnel on both sides of the intercompany transaction. In addition, it will also have to obtain relevant financial information, including

\textsuperscript{106} Memorandum for LMSB Executives, Managers, and Agents, January 22, 2003.

\textsuperscript{107} Reg. § 1.6662-6(d)(3)(ii).

\textsuperscript{108} Reg. § 1.6662-6(d)(2)(iii)(B).

\textsuperscript{109} Reg. § 1.6662-6(d)(2)(iii)(D).
internal cost accounting and profit margin analysis for the transactions at issue and the latest four years' financial statements. The taxpayer will have to identify unrelated party transactions, which may be between either two unrelated parties or one of the related parties and an unrelated party.

Example 5.19: USAco sells cheese to FORco, its foreign subsidiary, and wants to apply the CUP method to determine the appropriate transfer price. USAco has to interview the appropriate personnel to determine the price USAco charges unrelated parties in comparable cheese sales. In addition, USAco also needs to identify, to the extent available, the price charged on comparable sales of cheese by other cheese wholesalers.

The culmination of the information gathering process is the preparation of a functional analysis. This functional analysis reviews the functions performed and risks assumed by the respective parties, focusing on competition, the market, and other economic factors that may help to determine arm's-length pricing.

.03 Identification of the Best Method

The regulations require the taxpayer to apply the "best method" to its intercompany transactions. This requires choosing one of the methods prescribed in the regulations and supporting its applicability. At the same time, the taxpayer must explain why the other prescribed methods are not applicable. The taxpayer must review accurate and reliable data for application of the method; the degree of comparability between controlled and uncontrolled transactions or companies to which the methods are applied; and the number, magnitude, and accuracy of adjustments required to apply the method.\(^\text{109}\)

.04 Economic Analysis

The taxpayer should retain an economist to analyze the transactional data and obtain information concerning comparable companies from reliable databases.

Example 5.20: USAco, a U.S. subsidiary of ASIACo, a Singapore parent corporation, purchases software from its parent that USAco markets and sells in the U.S. USAco wants to apply the comparable profits method to determine the appropriate transfer price. USAco must find companies comparable to itself with respect to the type of functions performed and the risks assumed. As a result, the economist will have to search for potentially comparable companies based, for example, on disclosures required by the Securities and Exchange Commission, such as Form 10-K.

The economic analysis may further compare the financial results of the tested party to the financial results of the comparable transactions or companies. In addition to assuring functional comparability, an economist may also examine financial ratios such as return on costs, return on sales, and return on assets. Where appropriate, an economist may make adjustments for differences in relevant factors such as the relative levels of inventory, receivables, and payables.

\(^{109}\) Reg. § 1.482-1(d)(2).
.05 Transfer Pricing in Other Countries

The U.S. transfer pricing rules are generally more detailed and stricter than those in other countries. As a result, many of the United States' trading partners have become concerned that multi-nationals were reporting more income from intercompany transactions in the U.S. and less in the other country. Because of this concern, many of these countries have specifically adopted transfer pricing rules and many others have adopted the guidelines issued by the Organization for Economic Corporation and Development.110 A methodology and transfer price that the IRS may accept, may not, however, be acceptable to a foreign country's taxing authority. Many foreign countries have a preference for the transaction-based methods (i.e., comparable uncontrolled price method, resale price method, and cost plus method) as opposed to the profit-based methods (comparable profits method and profit split methods).111

Example 5.21: USAco, a U.S. subsidiary of CANco, a Canadian parent corporation, purchases oil from its parent that USAco markets and sells in the U.S. USAco properly applies the comparable profits method to justify to the IRS the transfer price of $100 a barrel. The Canada Customs and Revenue Agency audits CANco, disregards USAco's comparable profits method analysis, and applies a profit split method to support an adjustment to CANco, increasing the transfer price to $120 a barrel.

Although contemporaneous documentation provides protection in most developed countries from a transfer pricing penalty, the documentation in these foreign countries is not as rigorous as the U.S. 's requirement. For example, only Australia,112 Japan,113 and the Netherlands114 require that documentation explain why the taxpayer rejected the alternative methods.

The expense of preparing documentation for two different countries with respect to the same transaction may be fraught with danger. The methodology employed as well as the documentation requirements may differ in the two countries. As a result, the United States, in conjunction with the tax administrators of Australia, Canada, and Japan, announced documentation requirements that will provide penalty protection in multiple countries.115 Nevertheless, the documentation package does not provide certainty with respect to the different methods preferred in various countries.

505 DEVELOPING A TRANSFER PRICING STRATEGY

In the current environment, transfer pricing strategy is driven, to a great extent, by the need to develop an effective defense against the transactional and net adjustment penalties. The first step in developing a defense against these penalties is to assess the amount of risk associated with the taxpayer's current

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111 Culbertson, Robert E., “A Rose By Any Other Name: Smelling the Flowers at the OECD's (Last) Resort,” Tax Notes International, (August 4, 1995); Revenue Canada Information Circular 87-2.
112 Division 13 of Part III, Income Tax Assessment Act; Final Ruling TR 97/05.
position. One major determinant of risk is the aggregate dollar value of controlled transactions between U.S. and foreign affiliates. Another major determinant of risk is the relative profitability of U.S. and foreign operations, in particular, the percentage of the taxpayer’s worldwide profits that is allocated to low-tax foreign jurisdictions.

As a practical matter, the transactional penalty is likely to arise only if the taxpayer provides for no transfer price.\(^{116}\) In contrast, any large corporation with a significant volume of cross-border transactions could conceivably exceed the $5 million net adjustment threshold. For example, a company with $100 million of cross-border controlled transactions is potentially subject to the 20% penalty if its transfer prices are off by just 5%.

The only sure way to guard against the net adjustment penalty is to demonstrate, through contemporaneous documentation provided to the IRS within 30 days of a request, that the taxpayer acted reasonably in selecting and applying a transfer pricing method. As a consequence, the keys to avoiding the net adjustment penalty are the use of transfer prices which are supported by sufficient documentation and allocating to each affiliate a reasonable profit which reflects the economic realities of the parties’ contractual relations. In this regard, reliance on a transfer pricing study done by a professional qualified to conduct such an analysis, such as an attorney, accountant, or economist, is a relevant factor in determining whether the taxpayer selected and applied a transfer pricing method in a reasonable manner.\(^ {117}\) Therefore, a formal transfer pricing study, whether prepared internally by the taxpayer’s employees or externally through the use of outside consultants, is an important factor in establishing defensible transfer pricing positions.

An alternative strategy for avoiding the transactional and net adjustment penalties, as well as an adjustment, is to obtain an advance pricing agreement (or “APA”). Under the APA procedure, the IRS reviews and agrees to the taxpayer’s transfer pricing method before the taxpayer implements it.\(^ {118}\) An APA spells out the factual nature of the related party transactions, an appropriate pricing method, and the expected range of results from applying the agreed-upon method to the transactions. If the agreed-upon methodology is applied faithfully by the taxpayer, the IRS will not adjust the taxpayer’s transfer prices in any future audits. Thus, the advantages of an APA include the certainty of results for the taxpayer, as well as the possibility of reduced record keeping because the taxpayer knows in advance what information the IRS considers to be relevant. The disadvantages include the cost of developing the documentation needed to obtain an APA (including the opinions of independent experts), as well as the up-front disclosure of information to the IRS. Disclosure may be only a timing issue, however, for large multinational corporations which the IRS routinely audits. Although taxpayers may have some concern that they are disclosing

\(^{116}\) For example, if a domestic parent corporation transfers an intangible to a foreign subsidiary and does not provide for any royalty payments, then any price adjustment will exceed the 200% threshold.

\(^{117}\) Reg. \(\S\) 1.6662-6(d)(2)(ii)(D).

information about their company to potential competitors, the disclosure of the written APAs and any background documents is prohibited. Taxpayers that have traditionally benefited the most from APAs include large multinational corporations, companies with bad audit histories, conservative companies concerned about penalties, and U.S. subsidiaries of foreign multinational corporations. These businesses typically have significant transfer pricing exposure.

119 Code Secs. 6103 and 6110.