The Final Transfer Pricing Regulations: The More Things Change, The More They Stay The Same.

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====== SUMMARY ======

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In this article, the authors examine the final regulations under section 482. The authors analyze the manner in which these final regulations address key issues and concerns raised by previous versions of the regulations. The article analyzes the key questions confronting taxpayers as a result of the final regulations, including the following: the role of comparability in the final regulations; the priority of methods for transactions involving tangibles and intangibles; the role of the comparable profits method ("CPM"); the role of the profit-split method; the interaction of these regulations with the penalty regulations under section 6662; and how analysis prepared for planning purposes can be relied upon under these regulations.

The authors conclude that the final regulations, compared with the 1993 temporary regulations, provide taxpayers with greater flexibility. In exchange for the flexibility, taxpayers must prepare a well-reasoned analysis demonstrating why a particular transfer pricing methodology was chosen and the manner in which third-party data were used to establish arm's

length results. The authors argue that this flexibility may also imply greater controversy if taxpayers and revenue authorities disagree as to the choice of the best method and the application of unrelated party data to controlled transactions.

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I. Introduction

The July 1, 1994, release of the final intercompany pricing regulations under section 482 of the Internal Revenue Code /1/ marks the end of a nearly eight-year effort to implement the tax law changes of 1986. The Tax Reform Act of 1986 amended section 482 to mandate that intercompany charges for the use of intangible property be commensurate with the income attributable to the use of the intangible. /2/ This article analyzes the manner in which these final regulations address key issues and concerns raised by the change in the tax law.

While the Tax Reform Act of 1986 technically addressed only intangibles, the scope of the regulations-writing project broadened to include tangible property. In addition, the degree of guidance given taxpayers concerning the comparability of third-party data, and the choice of a specific method to assess whether the results of an intercompany transaction are arm's length, has increased with the final regulations. Table 1 provides a summary of the salient features of the final regulations and of three previous sets of regulations, as follows: those released in 1968 (the 1968 regulations), /3/ 1992 (the proposed regulations), /4/ and 1993 (the temporary regulations). /5/

The focus of most of the changes to the guidance for intercompany pricing has been on the rules addressing the transfer and use of intangible property. The 1988 White Paper recommended both a comparable method and an income method for determining arm's length transfer prices. /6/ Under the comparable method, prices associated with third-party transactions involving the same or very similar intangible property could be used as a guide in setting the intercompany price. Under the income approach, a basic arm's length return method (BALRM) established the arm's length return to the routine functions performed by each of the parties to a transaction, while any residual amount, attributed to nonroutine intangibles, was allocated to the party (or parties) owning the intangible. With each successive set of regulations, the standards of comparability to apply to arm's length payments for the transfer of intangible property have been more clearly defined.

A new method for analyzing the transfer of either tangible or intangible property, the comparable profits method (CPM), was first introduced with the proposed regulations, refined in the temporary regulations, and is further refined in the final regulations. Proposed new cost-sharing regulations were introduced in the proposed regulations, but no temporary or final regulations concerning this issue have been released yet. Finally, the regulations with respect to intercompany services have been finalized in their original 1968 form.

This article analyzes and discusses key implications of the final regulations. Following a brief overview of the regulations, questions are posed to address the major issues confronting taxpayers as a result of the final regulations. These questions include the following:

o How does the role of comparability in the final regulations differ from earlier versions of the regulations?

How do the final regulations alter the arm's length range concept?

o What is the priority of methods for transactions involving tangibles and intangibles?

o What is the role of the comparable profits method?

o What is the role of the profit-split method?

o How do the regulations for transfers of tangible and intangible goods interact?

o What additional guidance is provided in determining the periodic adjustments necessary to meet the commensurate-with-income standard with respect to royalty payments?

o In the temporary regulations, services, cost-sharing and lump sum payments were not addressed. How have these issues been addressed in the final regulations?

o How do the final regulations under section 482 interact with the penalty regulations under section 6662?

o Can an analysis based on data from uncontrolled comparables from prior years be relied upon given the contemporaneous results orientation of the regulations?

In general, the final regulations provide taxpayers more guidance and flexibility in determining and demonstrating arm's length results for intercompany transactions. The flexibility, however, comes at the price of documentation. That is, taxpayers must undertake a well-reasoned analysis demonstrating why a particular methodology was chosen and the manner in which data from unrelated transactions was employed to establish arm's length results for intercompany transactions. Without this documentation, the likelihood of section 482 adjustments, as well as penalties (of up to 40 percent), will increase. The increased flexibility may increase controversy if taxpayers and the IRS disagree on the choice of method or the application of uncontrolled party data to the taxpayer's intercompany transactions. Thus, it is essential for taxpayers to thoroughly document their choice and application of the best method to be able to respond to IRS assertions or analyses. Moreover, when preparing an analysis based on data from uncontrolled comparables from prior years, taxpayers should carefully monitor all relevant data to ensure continued comparability and arm's length results.

II. Overview of Final Section 482 Regulations

The final regulations have not fundamentally altered the guidelines established in the temporary regulations. With few exceptions, the methods that may be used to determine the arm's length character of intercompany prices also have not changed. The final regulations, however, provide more guidance as to the data that is necessary from unrelated parties to establish arm's length results. Consistent with the temporary regulations, the emphasis in the final regulations remains on comparability and documentation. In many cases, a taxpayer might have greater flexibility in the choice of a method than under the temporary regulations. For example, the profit-split method is a potential method, even in instances where one party does not possess nonroutine intangibles.

A. Arm's Length Standard and Best Method Rule

The final regulations modify only slightly the definition of the arm's length standard contained in the temporary regulations. Both the temporary and final regulations state that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if the uncontrolled taxpayers had engaged in the same transaction under the same circumstances." /7/ The final regulations, however, note that, "because identical transactions can rarely be located, whether a transaction produces an arm's length result will be determined by reference to the results of comparable transactions under comparable circumstances." /8/ This modification recognizes that although the arm's length standard requires related-party transactions to be evaluated on the same, rather than just similar, grounds as unrelated-party transactions, identical transactions between unrelated parties may be difficult, if not impossible, to identify. Thus, it is appropriate to evaluate controlled transactions by reference to uncontrolled transactions that are comparable but not necessarily identical. /9/

In selecting a method to determine whether an intercompany transaction is arm's length, the best method rule contained in the temporary regulations was modified in the final regulations to state that the method to be used is that which provides the most reliable (as opposed to the most accurate) measure of an arm's length result under the facts and circumstances. /10/ Several useful and instructive examples contained in reg. section 1.482-8 explicitly point to instances when certain methods are more appropriate than others. For example, a comparable profits method (which focuses on operating profit) is typically the best method when adjustments to data cannot be made to gross margins.

B. Comparability

The final regulations provide greater guidance than the earlier regulations regarding the evaluation of the comparability of uncontrolled transactions to controlled transactions. That is, the regulations more clearly define the degree of similarity and the adjustments to data that are required for a transaction to be considered comparable. Like the temporary regulations, the final regulations define comparability in terms of functions and risks, with explicit guidance given as to the functions and risks that should be evaluated before determining if third-party information yields acceptable functional or product comparables. While the basic comparability standards apply to all types of intercompany transfers and to any pricing methodology;

additional comparability requirements are specified for particular types of transactions and for the application of specific methodologies. Significantly, the final regulations recognize the use of inexact comparables in establishing arm's length results, although the reliability of the result may be reduced compared to the use of more exact comparables. /11/ The final regulations continue to allow taxpayers to account for special market penetration strategies or location savings, but do not allow prices to differ from those that would ordinarily be deemed arm's length to pursue a business strategy that is designed to maintain market share. /12/ The final regulations also provide explicit guidance as to when isolated transactions may be used as comparables. /13/ As in the temporary regulations, the final regulations recognize the need to establish an arm's length range of prices rather than a single price. If precise adjustments for differences in functions, risks or data cannot be made, the final regulations limit the range of arm's length results to the interquartile (or middle 50 percent) range of the results. Unlike the temporary regulations, this interquartile range applies to all methods, not just the comparable profits method. /14/

C. Functional and Risk Analysis

No changes from the temporary regulations were made regarding the degree of functional and risk analysis that should be performed in analyzing intercompany transactions. Recognizing that it can be either difficult or impossible to find transactions between unrelated parties that are exactly comparable to the controlled transactions, the regulations expand the potential universe of comparables to include inexact comparables, provided appropriate adjustments can be made. Thus, it is likely that more analysis of potential comparables will be necessary to demonstrate that the transfer pricing policy satisfies the arm's length standard. The final regulations require a comparison of the functions performed, resources employed, and significant risks assumed by each party to a transaction when determining the degree of comparability between controlled and uncontrolled transactions. /15/ A functional analysis has regularly been used both by the IRS and by taxpayers to determine where in a group of controlled entities economically significant activities are performed, as well as to evaluate the comparability of controlled and uncontrolled transactions. /16/

D. Special Rules

As with the temporary regulations, the final regulations provide for a number of special rules with respect to intercompany pricing. Arm's length ranges can be set using multiple-year data to account for unusual events, cyclical fluctuations, or data deficiencies. /17/ Similarly, transactions involving more than one product or product line may be aggregated in determining an arm's length result if it is impractical to do otherwise. /18/ For small taxpayers, the final regulations no longer provide a safe haven as outlined in the temporary regulations.

Special rules for the accounting treatment of section 482 adjustments mirror those outlined in 1993 in terms of establishing collateral accounting adjustments and allowing non-arm's-length results of one transaction to be offset by non-arm's-length results from other transactions. /19/ Rather than requiring taxpayers to make compensating adjustments in their books to comply with the arm's length standard, the final regulations provide that differences between tax and book records can be accounted for on Schedule M of Form 1120. /20/ Taxpayers may also "true-up" their books and records prior to filing a tax return.

E. Methods for Sales of Tangible Property

The methods for evaluating the intercompany transfer of tangible property remain fundamentally unchanged from those outlined in the temporary regulations. Six distinct methods are recognized, with no priority among the methods (although the comparable uncontrolled price method is recognized to yield the most reliable results if sufficient data are available). For each method, the comparability and types of adjustments required have become more explicit than in the temporary regulations.

The comparable uncontrolled price method (CUP), which is based on transactions of the same or similar property, has been expanded to include inexact comparables and, where appropriate, published commodity prices. /21/ The resale price method (RPM) establishes arm's length results by reference to gross margins of comparable resellers. /22/ The RPM is frequently used in situations in which a controlled entity purchases goods from another controlled entity for resale without physically altering the product or adding any substantial intangible value. The cost-plus method is generally used when one party involved in the controlled transaction produces or otherwise physically transforms the product and the reseller adds substantial value to the

goods. The cost-plus method establishes arm's length results from the application of the ratio of gross profits to the cost of goods sold from third-party transactions. /23/ Under both the resale price and cost-plus methods, the final regulations are consistent with the emphasis in the temporary regulations on making adjustments to gross margins for material differences between the controlled and uncontrolled transactions that would affect the gross margin. /24/ The comparable profits method (CPM) and profit-split methods are two additional methods described below. The resale price, cost-plus, comparable profits, and profit- split methods all rely on functional comparables in which the functions and risks associated with uncontrolled transactions correspond to the functions and risks of one of the related parties.

The sixth method refers to any "unspecified" method that might be applicable to the facts and circumstances of a transaction. For example, an unspecified method might refer to bona fide quotations for products for which no transaction may exist. /25/ While the temporary regulations would have required that the use of a profit- split or unspecified method be disclosed to the IRS with the filing of a tax return, the final section 482 regulations do not contain any such requirement. The amended penalty regulations under section 6662 do, however, require that the use of such methods be disclosed. /26/

F. Methods for Transfer or Use of Intangible Property

The transfer of the use of intangible property is governed by four methods. Under the comparable uncontrolled transaction method (CUTM), the arm's length charge is determined by reference to prices obtained in third-party transactions involving the same or similar intangibles under similar circumstances. /27/ Like the CUP method for tangible property, the application of the CUTM is broadened (compared to the temporary regulations) to include inexact comparables as long as such comparables (after adjustments) provide a reliable measure of arm's length results. While the CUTM will ordinarily yield the most reliable results if exact comparable license agreements are available, the comparable profits method (discussed below) may also be used for determining arm's length results. The two other methods are the profit-split method and any unspecified method. For intangibles, intercompany arrangements covering more than one year require periodic adjustments to insure that the commensurate-with- income standard is met. /28/ No periodic adjustment is required when certain conditions are met, including the notion that profits (or cost savings) attributable to the use of the intangible remain within 80 to 120 percent of

the amounts foreseen when the agreement was determined to be arm's length. Unlike the temporary regulations, the final regulations provide for an exclusion to periodic adjustments if during the first five years of the agreement no periodic adjustment was required. /29/ The final regulations also contain guidance as to the calculation of lump sum payments. Such payments constitute advance payment for an equivalent stream of royalties subject to periodic adjustments. /30/

G. Services and Cost-Sharing

As they pertain to the performance of intercompany services, the final regulations remain unchanged from the 1968 regulations. Reg. section 1.482-1(b)(2)(ii), however, states that "different methods" may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property to determine an arm's length result.

The final regulations also do not include new guidance with respect to cost-sharing. The preamble to the regulations states that the temporary regulations continue to apply; these regulations incorporate the text of the 1968 cost-sharing regulations. /31/ Final regulations that are expected to be released "in the near future," however, will be based on the proposed regulations. The final cost- sharing regulations will apply the commensurate-with-income standard to cost-sharing payments. If they closely follow the proposed regulations, the final cost-sharing regulations will provide specific guidance concerning what constitutes a bona fide cost-sharing arrangement, buy-in payments, and specific rules for determining each participant's cost-sharing contribution.

H. Comparable Profits Method

The comparable profits method remains as it was defined in the temporary regulations. That is, the CPM assigns an arm's length return for the controlled transfer of tangible or intangible property based on various "profit level indicators" of uncontrolled parties performing activities similar to those of the controlled "tested party." /32/ The participant in a controlled transaction whose operating profit is analyzed (tested party) is typically the least complex in terms of functions, risks, and

ownership of intangibles. Thus, it can readily be compared to uncontrolled comparables, while requiring the fewest adjustments. /33/ The profit level indicators reflect measures of the ratio of operating profits to assets or costs, with the choice of the appropriate indicator dependent on the circumstances, facts, and available data. /34/ The final regulations provide greater guidance than the temporary regulations as to the types of adjustments required to employ each profit level indicator. /35/

I. Profit-Split Method

Under the final regulations, the profit-split method has equal priority with other specified methods. Two of the three profit-split methods contained in the proposed profit-split method regulations are retained in the final regulations. Both of these methods rely on the use of third-party comparables. The profit-split method based on the relative amounts of capital employed was not included in the final regulations. Under the comparable profit-split method, the combined profit of the controlled parties is allocated to each party in accordance with the percentage allocation of the combined profits of uncontrolled parties whose transactions and activities are similar to those of the controlled parties. /36/ Practically, the difficulty of identifying comparable uncontrolled parties involved in similar activities under similar circumstances would render this method unworkable in most cases. The other profit-split method, the residual allocation rule, closely follows the BALRM approach first defined in the White Paper. /37/ Under this approach, the returns to the routine activities performed by controlled parties to a transaction are determined by identifying returns achieved by comparable third parties. An arm's length amount of operating income is then assigned to each related party based on its routine contributions to the relevant business activity. /38/ The residual profit is then allocated among the related parties based on the relative value of their contributions. While the regulations encourage the determination of relative value of intangibles to be based on some market measure of value, they recognize that often the best available measure will be based on relative capitalized intangible development costs. /39/

J. Penalties Under Section 6662

While the section 482 regulations provide guidance on how to evaluate whether the results of intercompany transactions are arm's length, the major incentive that taxpayers have to apply these guidelines rests with the documentation they are required to provide to the IRS to avoid penalties imposed under section 6662. The temporary and proposed section 6662 regulations issued on February 2, 1994, implement the transfer pricing penalties as amended by the Omnibus Budget Reconciliation Act of 1993 (the 1993 act). These regulations outlined extensive contemporaneous documentation and analysis that must be undertaken by taxpayers before filing the tax return to qualify for "reasonable cause" exception and thus avoid penalties. The amendments to the section 6662 regulations, issued on July 5, 1994, do not change the degree of contemporaneous documentation that taxpayers must prepare. The amendments to the section 6662 regulations revise the regulations and bring them into closer conformity with the best method rule of the final section 482 regulations. In addition, the amendments contain disclosure requirements for the use of the profit-split or unspecified methods, as well as lump sum payments. The requirement to disclose the use of the profit-split or unspecified methods is not contained in the final 482 regulations, although it had been included in the 1993 temporary regulations.

III. The Role of Comparability

Question 1: How does the role of comparability in the final regulations differ from earlier versions of the regulations?

Answer 1: The final regulations provide increased flexibility in establishing comparability between controlled and uncontrolled transactions. The regulations better articulate the factors to be considered in evaluating comparability,, sanction the use of "inexact comparables," and specify the adjustments needed to improve reliability or comparability.

The final regulations place a strong emphasis on the evaluation of comparability between controlled and uncontrolled transactions and firms in determining the best method to test the arm's length nature of intercompany transfers. Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.

The 1968 regulations contained limited guidance for taxpayers in evaluating comparability. The proposed regulations contained increased guidance in the form of strict comparability rules. The temporary regulations clarified the standards of comparability to be used in evaluating the arm's length nature of intercompany transactions, specified a number of factors for comparing controlled and uncontrolled transactions, and established an explicit distinction between product and functional comparability. In using the comparable uncontrolled price method, for example, product comparability was required, whereas functional comparability between the controlled and the uncontrolled companies was required when using the resale price or cost-plus methods.

The final regulations build upon many of the standards of comparability introduced in the temporary regulations. Under the standards of the final regulations, however, an uncontrolled transaction does not have to be identical or exactly comparable to the controlled transaction. Rather, it must be "sufficiently similar that it provides a reliable measure of an arm's length result." /40/ Thus, in demonstrating comparability, the taxpayers may now use inexact, as well as exact, comparables. In determining comparability, the final regulations require that all functions or activities undertaken by a controlled group be evaluated through a functional analysis. A functional analysis should also consider the resources that are employed in conjunction with the activities undertaken, including consideration of the type of assets used. /41/ The final regulations further state that a thorough analysis of the risks borne by the parties to a controlled transaction and by the parties to potentially comparable transactions must be undertaken. /42/ In assessing whether a controlled taxpayer bears a particular economic risk, a number of factors are to be considered, such as the pattern of the controlled taxpayers' conduct over time, the controlled taxpayer's financial wherewithal to absorb potential losses from the assumption of such risk, and the controlled taxpayer's influence over the business activities that will potentially result in either income or losses. /43/ The final regulations also discuss significant contractual terms and economic conditions that must be considered in determining comparability. Differences in contractual terms, such as the form of consideration charged or paid, sales or purchase volume, the scope and terms of warranties provided, and the duration of the contract could lead to differences in the results of the controlled and uncontrolled transactions.

The final regulations require adjustments to be made if the effect of material differences between the controlled and uncontrolled transactions (companies) on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. /44/ The temporary regulations stated that adjustments should be made to account for material differences between the controlled and uncontrolled transactions if such differences had a definite and reasonably ascertainable effect on prices or profits. /45/ Thus, the final regulations suggest that adjustments should be made if it is likely that they contribute to the reliability of the results even if it cannot be shown that such differences had a precise impact on prices or profits. To the extent that complete adjustments for material differences cannot be made, under all methods, the interquartile or some other statistical limitation of the range of results will be used to establish the arm's length range. /46/ Thus, the final regulations use the degree of precision that can be applied in making adjustments to determine whether the full range of results for comparables or a limited range of results should be used to establish the arm's length range. Another critical change is that the final regulations explicitly state that unadjusted industry average returns themselves cannot establish arm's length results. /47/ Clearly, the final regulations prefer quality to quantity in choosing comparables.

The detailed guidance provided in the final regulations will enhance taxpayers' ability to establish and support their transfer pricing policies in accordance with the arm's length standard. In many cases, the standards of the final regulations will allow a taxpayer greater flexibility in the selection of comparables than was provided under the temporary regulations. Like the temporary regulations, however, the final regulations place strong emphasis on documentation. /48/ That is, emphasis is placed on explaining the selection of a best method and justifying the comparables that have been chosen.

IV. The Arm's Length Range

Question 2: How do the final regulations alter the arm's length range concept?

Answer 2: The final regulations permit a taxpayer to show that its transfer price falls within an arm's length range, but narrow that range when there is doubt as to the quality or reliability of the comparables selected.

The temporary regulations, for the first time, recognized that there may be more than one arm's length transfer price and introduced the concept of a range of arm's length transfer prices. The arm's length range was determined by applying a single pricing method using two or more uncontrolled comparables.

Under the temporary regulations, the arm's length range concept was modified slightly for the CPM to account for the relaxed comparability standards of the CPM. The temporary regulations specified that the entire range of constructive operating profits derived through application of the CPM was considered an arm's length range only if there existed at least a broad similarity between the controlled and uncontrolled parties. /49/ The concept of the interquartile range (the middle 50 percent) was introduced as a means of compensating for the lower standard of comparability permitted under the CPM.

The final regulations reaffirm the arm's length range concept, stating that the arm's length 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 reliability." /50/ The final regulations also significantly broaden the use of the interquartile range by allowing its application to methods other than the CPM. When it is not possible to make an adjustment to eliminate material differences between the uncontrolled transactions and the controlled transactions, the final regulations specify that a taxpayer may increase the reliability of the analysis by using either an interquartile range or some other statistically equivalent measure in determining an arm's length range. /51/

The final regulations provide guidance in calculating the interquartile range by specifying the formula to be applied to third-party data in computing the interquartile range. The final regulations also permit a taxpayer to make use of other statistically equivalent measures in determining the arm's length range of returns. Expanding the use of the interquartile range to all methods implies that, in most cases, the IRS may be less likely to propose an adjustment if the taxpayer is in the interquartile range.

V. The Priority of Methods

Question 3: What is the priority of methods for transactions involving tangibles and intangibles?

Answer 3: The final regulations do not prioritize the methods for evaluating transfers of tangible and intangible property, but rather maintain the temporary regulations' reliance on the best method rule. The regulations implicitly favor the CUP and CUTM methods, but permit a taxpayer to use any method, including inexact comparables, as long as it is documented as the best method (i.e., most reliable for demonstrating that transfer prices are arm's length).

Like the temporary regulations, the final regulations do not prioritize the methods for evaluating transfers of tangible and intangible property. Rather, for both types of transfers, the chosen method must be in accordance with the best method rule. /52/ The implication of the final regulations is that, while taxpayers are granted a great deal of flexibility in choosing a method for evaluating their intercompany transfers, they must also bear the accompanying responsibility of exercising good judgment in applying this flexibility. Specifically, taxpayers must be prepared to show that the application of a particular method, using chosen comparables, provides the most reliable measure of an arm's length result under the facts and circumstances. /53/ It is quite possible that this increased flexibility and exercise of judgment will lead to an increased number of disputes between taxpayers and the IRS over transfer pricing issues. That is, taxpayers must document the reason for choosing a method to be able to respond to IRS inquiries.

The best method rule in the final regulations has the primary role in determining the method to be used to evaluate a controlled transaction. Under the rule, "[t]he 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. . . . [N]o method will invariably be considered more reliable than others." /54/ The choice of the best method is dependent on the evaluation of the following two criteria: (1) the degree of comparability between the controlled transaction or taxpayer and the uncontrolled comparables, and (2) the quality of the data and assumptions used. /55/ While the regulations contain an extensive discussion of factors to be considered when evaluating comparability and the quality of data and assumptions, there are few, if any, instances in which the regulations state that a method cannot be used. Rather, in virtually all cases, it is less than complete comparability and deficiencies in data or assumptions that reduce the reliability of the method to measure an arm's length result. Thus, a taxpayer (or the IRS) should typically judge the relative reliability of results under more than one method to determine the best method. /56/

While guidelines are provided to indicate the circumstances under which each of the six potential methods may provide the most reliable results for the transfer of tangible property, the final regulations contain no specific prioritization of the methods. Rather, the reliability of the results using an application of a specific method depends on the comparability of the uncontrolled transactions, the quality of data available, and the reliability of assumptions used. For example, the regulations state that "[t]he results derived from applying the comparable uncontrolled price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price," or if there are differences that either would not affect the price or for which appropriate adjustments can be made. /57/ While the CUP method has been expanded to include inexact comparables, it is noted that significant adjustments might be required to use inexact comparables, rendering the results of using inexact comparables under this method less reliable. Thus, while the CUP method generally may have implicit priority, it may not necessarily have such priority over other methods when used with inexact comparables.

Similar to the rules for evaluating transfers of tangible property, the methods for evaluating the transfer of intangibles receive no prioritization; rather, the reliability of results must be evaluated under the criteria of the best method rule, although the CUTM is regarded to yield the most reliable results if the data are available. As with tangible property, if the CUTM is used with inexact comparables, the implicit priority given this method does not necessarily exist.

VI. The Role of CPM

Question 4: What is the role of the comparable profits method (CPM)?

Answer 4: The final regulations place less emphasis on the CPM than the temporary regulations and permit taxpayers greater flexibility in the selection of the tested party under the CPM. The regulations additionally alter IRS adjustment procedures to provide that the adjustment in any one year will be to the midpoint of the comparables' data for that year and not the multiple-year average for the comparables.

The CPM remains one of the methods specified to analyze the pricing of intercompany transfers of both tangible and intangible property. The final regulations have not altered the basic operation of the CPM, but they have made five important changes and clarifications to this method. These changes are as follows:

(1) less preference given to using the CPM;

(2) flexibility over choice of the tested party;

(3) expanded discussion of comparability;

(4) more guidance on applying profit level indicators; and

(5) different IRS adjustment procedures when using multiple
year data.

In response to comments by practitioners and foreign tax authorities who felt that the CPM was given preference over some other specified methods in the temporary regulations, the final regulations make it clear that the CPM is subject to the same consideration as the other specified methods. In addition, the preamble to the final regulations actually states a preference for other specified methods, "Given adequate data, methods that determine an arm's-length price (e.g., the CUP method) or gross margin (e.g., the resale price method) generally achieve a higher degree of comparability than the CPM." /58/ Thus, if comparability can be established and appropriate data exist, the CPM may not be the "best method."

The final regulations have modified the choice of which party in the controlled transaction should be considered the "tested party." The temporary regulations stipulated that the tested party would not own valuable nonroutine intangibles. The final regulations only stipulate that the tested party be the controlled party with ". . . the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located." /59/

Although this process could result in a taxpayer with valuable intangibles being selected as the tested party, the final regulations say that in most cases the tested party will not own valuable intangible property. /60/

The factors for determining the comparability of companies to the taxpayer both expands on the guidelines of the temporary and proposed regulations and also adds some new factors to consider. The final regulations state that comparability under the CPM is particularly dependent on resources employed and risks assumed, while less dependent than other methods on functional and product comparability. /61/ Resources employed may include tangible assets such as plant and equipment, intangible assets, and working capital. /62/

Similar to the temporary regulations, the final regulations suggest comparing the profitability of the comparables with the tested party by looking at return on capital employed (operating income/operating assets), financial ratios, and other profit level indicators. The chosen profit level indicators should only be applied to the controlled transactions in the relevant business segment for the tested party. When isolating the relevant business segment for the tested party (or the comparables), costs and assets not reflected in the segment's financial statements must be appropriately allocated to that segment. Specifically, the final regulations explain that if these allocations cannot be made directly based on factual relationships, a reasonable allocation formula may be used. To the extent that nondirect allocations are utilized, the reliability of the results of the application of the CPM will be reduced relative to the results of a method that does not require such allocations. /63/

The final regulations alter the guidelines for how the IRS makes adjustments to the tested party's taxable income when using the CPM. The final regulations specify that the tested party's profits are initially compared to the profits of its comparables over a multiple- year period (typically the year in question plus the two previous years). When the tested party's profits are outside the range of profits for the comparables over the multiple-year period, the tested party's profits in each year under examination would be adjusted to the midpoint of the range for that year. (Under the temporary regulations, the basis for adjustment would be the comparables' profits in the multiple-year period.) Even if only one year's adjustment would place the

tested party's multiple-year profitability in the interquartile range of the comparables in subsequent years, an adjustment in subsequent years will occur. In fact, penalties may be assessed for each of the years in question under this procedure.

This change in the final regulations has the potential to increase the adjustments and associated penalties associated with transfer pricing. Thus, the amount of an IRS adjustment is not dependent on multiple-year data, but only on the comparables' profits from the year under examination. This change implies that the IRS, in making an adjustment, will use multiple-year data only to determine if an adjustment is warranted, but not to determine the size of the adjustment.

The final regulations for the CPM are generally consistent with the temporary regulations. Since the final regulations have increased the applicability and the number of other specified methods, the use of the CPM should decrease. This decreased emphasis on the CPM responds to the comments made by foreign governments that the CPM was given too much emphasis under the temporary regulations.

VII. The Role of Profit-Split

Question 5: What is the role of the profit-split method?

Answer 5: The final regulations accord the profit-split method equal status with other specified methods of analysis and permit its use under a wider set of circumstances than under the proposed regulations. While the regulations describe only two types of profit splits, taxpayers may use the profit-split method more often.

The profit-split method is now categorized as one of the specified methods for transfers of both intangible and tangible property. As a specified method, profit-split may be employed without proving the inapplicability of every one of the other specified methods. Unlike the requirements of the temporary regulations, it is not necessary for each controlled party of a transaction to own valuable nonroutine intangibles to employ the profit-split method. Furthermore, only disclosure, as opposed to a binding election, of the use of a profit-split method is now required to avoid penalties under section 6662.

To employ the profit-split method, one must use either the comparable profit-split or the residual profit-split approach. One other profit-split method described in the temporary regulations, the capital employed allocation rule, has not been included in the final regulations.

The comparable profit-split method divides the total operating income of the buyer (or licensee) and the seller (or licensor) in the controlled transaction in a manner that is consistent with the way comparable unrelated parties divide their operating income in similar transactions. One must therefore find data on comparable transactions and resulting profit-splits between unrelated parties. That is, two independent parties, each having risks, functions, and intangibles comparable to those of the controlled parties, must be identified. The use of this method will be limited because (1) it will be difficult to find comparable companies engaged in transactions that are similar to those of both the buyer and seller, and (2) data delineating how the independent parties shared the combined profits from a comparable transaction rarely exists. Finding a comparable transaction is made more difficult because the final regulations state that comparability is dependent on the degree of similarity not only of the functions risk, but also of the contractual terms. /64/ The final regulations also state that comparable profit-split ". . . may not be used if the combined operating profits . . . of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers." /65/ Since these constraints on data and comparability make it difficult to apply comparable profit-split, most profit-split analyses will be applied using the residual profit- split.

The residual profit-split first assigns an arm's length return to the routine activities of the buyer and the seller in the controlled transaction. This allocation is performed by first granting the buyer and seller an arm's length return for functions they perform that contribute to profits. These functions include manufacturing, distributing, marketing, the performance of services, and the exploitation of routine intangibles. Whatever profit remains after this allocation (the residual) is then split between the buyer and seller.

There is no set method by which to split the residual, but the final regulations prefer that this split use some market benchmark. /66/ A market benchmark would yield insight on the value of intangibles. The regulations provide no guidance as to what constitutes a market benchmark. One possibility might be to split the residual profit based on relative royalty rates

contained in arm's length license agreements. For example, where the residual profit is attributable to a trademark owned by one party and a patent owned by the other party, the split could be derived based on the relative royalty rates obtained from inexact comparable arm's length license agreements. Thus, if the comparable trademark royalty rate is 2 percent of net sales and the comparable patent royalty rate is 3 percent of net sales, two-fifths of the residual profit might be allocated to the owner of the trademark and the remaining three- fifths would be allocated to the owner of the patent. If market benchmarks are not available, another method of dividing the residual must be used. The final regulations mention dividing the residual based on the capitalized costs of intangible development incurred by the buyer and seller, but the regulations also state that the reliability of the residual profit-split will diminish without the use of market benchmarks to divide the residual. /67/

The flexibility for using the profit-split method has increased dramatically in the final regulations. This increase can be attributed to its classification as a specified method and the ability to use the method even when both controlled taxpayers do not own valuable nonroutine intangibles. (It may also reflect a recognition by the IRS that it is the only viable method in many situations.) Furthermore, the removal of the requirement to make a binding election to use this method may lead more taxpayers to apply this method.

VIII. Interaction Between Regs for Transfers of Tangible and Intangible Property

Question 6: How do the regulations for transfers of tangible and intangible goods interact?

Answer 6: The final regulations provide guidance to taxpayers in setting transfer prices for goods with intangible property "embedded" in them. The guidance implies that there may be circumstances in which activity that enhances a trademark should be analyzed separately from purely resale activity; however, ordinary resales of branded property should generally be evaluated under the rules for tangible goods.

The final regulations provide clear guidance on the interaction between the rules for tangible and intangible property. They specifically address cases in which intangible value is "embedded" in the controlled sale of tangible property, both when the

embedded intangible is used in the normal course of reselling the goods, and when it is further developed by the controlled purchaser. The rules also clarify the meaning of the term "owner" of intangible property, for transfer pricing purposes. Finally, the regulations present a series of examples to provide further guidance on these points. The overall implication of the rules is that while there may be circumstances in which the controlled purchaser of tangible property may also be required to pay a royalty to the seller of such property, ordinary resales of branded tangible property should generally be evaluated under the rules for tangible goods.

Generally, if tangible property with an "embedded intangible" is transferred in a controlled transaction, the transfer should be evaluated as a transfer of tangible, not intangible, property. As such, one of the six specified methods for evaluating transfers of tangible property should be applied. This rule remains valid if the controlled purchaser does not acquire any rights to exploit the intangible other than under normal commercial practices associated with the resale of the product. /68/

Nonetheless, an embedded intangible must be accounted for in the evaluation of comparables. For example, if tangible property has an intangible attached to it (i.e., a trademark), an otherwise comparable uncontrolled price of the same (but unbranded) good may not be usable under the comparable uncontrolled price method. /69/ Furthermore, under the resale price and cost plus methods, "significant differences in the value of [the products] due, for example, to the value of a trademark, may also affect the reliability of the comparison." /70/ As with the comparable uncontrolled price method, the distribution of unbranded goods should not be considered a comparable transaction to the controlled distribution of branded goods. /71/

If a transfer of tangible property with an embedded intangible conveys the right to the purchaser to exploit the embedded intangible, an arm's length consideration for the intangible property may need to be determined separately from that for the tangible property, using one of the four methods applicable to transfers of intangible property. /72/ For example, a company may develop a proprietary manufacturing process. To take advantage of this manufacturing process, the company may also develop or configure machinery. When it sells the machinery to a subsidiary, however, the price of the machinery may not reflect an arm's length consideration for the manufacturing process that has been developed by the parent and transferred

with the machinery. In this case, an arms' length return to the manufacturing process should be determined using the rules for transfers of intangible property.

The regulations also allow that for transfer pricing purposes, there may be more than one "owner" of intangible property. Specifically, if the owner of a trademark licenses the exclusive right to use that trademark in a given area for a given period of time, both the licensee and licensor will be considered owners of the intangible property, and each must receive arm's length consideration commensurate with the income attributable to the use of the property. /73/ A series of scenarios discussed in the regulations attempt to clarify this point. Summaries of several of these scenarios are provided below.

FP, a non-U.S. producer of cheese, markets its cheese worldwide except in the United States. The cheese carries a trade name that is well-known outside the United States. USSub is later established to distribute the cheese in the United States. USSub undertakes all marketing and advertising to develop the name in the United States. As long as comparable uncontrolled U.S. distributors incur comparable marketing and advertising expenses to develop the names of the cheeses they distribute, no reimbursements with respect to market development activities would be required from FP to USSub. On the other hand, if USSub is found to have incurred much higher market development and marketing expenses than independent cheese distributors in the United States, FP must compensate USSub for the "fair market value of the services that USSub is considered to have performed for FP." Finally, under a third scenario, FP and USSub have entered a long-term agreement granting USSub the exclusive right to distribute cheese in the United States under FP's trade name. As long as the price of the cheese USSub purchases from FP is arm's length (under the rules for tangible property), USSub will derive all benefit from the resale of the branded product in the United States, including any enhanced value of the tradename. /74/ These examples, while attempting to clarify when an intangible is embedded with a tangible, may lead to confusion and controversy. Identifying a comparable that has similar exploitation rights may be difficult, and if such a comparable cannot be found, a separate analysis of the value of the intangible may be necessary.

IX. Periodic Adjustments to Royalties

Question 7: What guidance is provided in determining the periodic adjustments necessary to meet the commensurate-with-income standard with respect to royalty payments?

Answer 7: The final regulations appear to relax the commensurate-with-income standard and specify new circumstances under which periodic adjustments of royalty rates will be unnecessary. While the number of instances in which periodic adjustments are required will be reduced,, complicated annual calculations to determine the necessity of an adjustment will be necessary.

Almost by definition, the commensurate-with-income standard implies that taxpayers must make periodic adjustments to royalties to reflect the changes in profitability attributable to the use of an intangible. That is, the income attributable to the use of an intangible can vary from year to year, depending on a variety of factors, implying that the royalty can vary. For example, a product produced under patent protection may exhibit high levels of profit until such a time as a better product is introduced. The determination of whether a royalty payment meets the arm's length requirements in a given year is independent of whether a similar payment met the standard in prior years. /75/ The final regulations stipulate that periodic adjustments to agreed-upon intercompany royalty arrangements can be avoided if a variety of conditions are met.

Adjustments to royalty payments are not required when the royalty payment is based on the payment made for the same intangible transferred to an uncontrolled party under similar circumstances as long as the amount paid in the first year met the arm's length criteria. /76/ This requirement for exact comparables reflects a relaxation of the periodic adjustment standard contained in the temporary regulations, which required a profitability test. The relaxation of the strict commensurate-with-income standard reflects both (1) the fact that when exact comparables exist, they reflect arm's length results; and (2) an approach to royalty payments more consistent with the approaches taken by the OECD and non-U.S. tax authorities.

To avoid periodic adjustments in royalty payments when either inexact comparables or other transfer pricing methods (including lump sum payments) are used, a series of requirements similar to those contained in the temporary regulations

must be met. These requirements include (1) the existence of a written agreement covering the period of the license; (2) no change in the roles of the licensor and licensee since the agreement was executed; and (3) that the total profits earned (or costs saved) from the exploitation of the intangible in the year under examination and in all past years must lie between 80 and 120 percent of the profits (or cost savings) foreseen at the time the agreement was entered. /77/ The only difference between these regulations and the temporary regulations is the fact that the 80-to-120 percent test can be met over a period of time other than in just the current year. This implies that a fluctuation in profitability in the current year may not trigger a periodic adjustment as long as the total fluctuation since the date of the agreement lies, in the aggregate, between 80 and 120 percent of the profits anticipated at the time the agreement was entered.

Periodic adjustments are also not imposed under two other conditions, regardless of the method used to determine royalties. If an extraordinary event prevents a taxpayer from meeting the 80-to- 120-percent test, no adjustment occurs in the agreed royalty. /78/ New to the final regulations is an exception to adjustments when no adjustment has occurred under these rules for each of five consecutive years, commencing with the first year of the agreement. /79/ Thus, if the related-party agreement meets the profitability and other tests during its first five years, no subsequent adjustments to royalty payments will occur. If a taxpayer was not audited during the first five years, however, an audit in year 6 may still trigger an adjustment if the IRS determines the five-year exception was not met.

The criteria to avoid periodic adjustments to royalty payments appear to address some of the concerns expressed by many non-U.S. tax authorities. That is, many non-U.S. tax authorities were critical of the temporary regulations because they required periodic adjustments even though unrelated-party arrangements do not require such adjustments. At the same time, some may contend that any periodic adjustment is inconsistent with most third-party license agreements.

Allowing the use of additional years of data in determining whether the profitability test is met, and allowing a safe harbor if there is no adjustment for the first five years of the agreement, suggests a lessening of the commensurate-with-income standard from the temporary regulations. To many taxpayers, this provides greater flexibility avoiding periodic adjustments. Nonetheless, complicated annual calculations will still be required to determine if an adjustment is necessary.

X. Services, Cost-Sharing, Lump Sum Payments

Question 8: In the temporary regulations, services, cost- sharing, and lump sum payments were not addressed. How have these issues been addressed in the final regulations?

Answer 8: The final regulations provide no new guidance on payments for services or cost-sharing arrangements. The regulations provide a method for calculating an arm's length lump sum payment for intangible property by converting lump sum payments to an equivalent royalty stream. This lump sum payment will be subject to adjustment annually during the life of the intangible (or the period covered by an agreement,, if shorter).

As they pertain to the performance of intercompany services, the final regulations remain unchanged from the 1968 regulations. Reg. section 1.482-1(b)(2)(ii), however, states that "different methods" may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property to determine an arm's length result.

The final regulations also do not include new guidance with respect to cost-sharing. The preamble to the regulations states that the temporary regulations continue to apply; these regulations incorporate the text of the 1968 cost-sharing regulations. /80/ However, final regulations, expected to be released "in the near future," will be based on the 1992 proposed regulations. The final regulations will apply the commensurate-with-income standard to cost- sharing. If they closely follow the proposed regulations, the final cost-sharing regulations will provide specific guidance on what constitutes a bona fide cost sharing arrangement and specific rules for determining each participant's cost-sharing contribution.

If the final regulations do, in fact, closely follow the proposed regulations, they will prevent taxpayers from establishing cost-sharing agreements that "cherry pick" only successful research and development projects or that mismatch costs and expected benefit. The regulations are also expected to address the problem of buy-ins for research projects already underway at the start of an engagement. /81/

The final regulations for the first time provide a method for determining an arm's length lump sum payment for an intangible. Whether the payment is arm's length will be based on a determination of what the equivalent royalty payment would have been. The lump sum must be decomposed by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible or the period covered by the license agreement. /82/ Thus, in determining lump sum payments, the general rules for intangibles should be used to assess whether the implicit royalty, given sales forecasts and assumptions regarding discount rates, is supportable as arm's length.

The final regulations note that the equivalent royalty amount is subject to periodic adjustments as would an actual royalty rate. Thus, the lump sum payment will be subject to adjustment annually during the useful life of the intangible (or the period covered by an agreement, if shorter). Also, the same exceptions to periodic adjustments that apply to actual royalty amounts apply to the equivalent royalty amount. It should also be noted that the methodology for lump sum payments for intangible property will likely be incorporated in final cost-sharing regulations in terms of buy-in and buy-out payments.

XI. Interaction With Section 6662 Penalty Regs

Question 9: How do the final section 482 regulations interact with the proposed and temporary penalty regulations under section 6662?

Answer 9: The amended proposed and temporary section 6662 penalty regulations provide the stick to ensure taxpayers comply with the transfer pricing guidelines outlined in the regulations under section 482. To avoid penalties taxpayers must carefully document how the results of their intercompany pricing practices conform to the requirements of the section 482 regulations.

To avoid penalties, taxpayers with intercompany transactions need to follow temporary and proposed regulations issued on February 2, 1994, implementing the transfer pricing penalty as amended by the 1993 act. These regulations outline extensive contemporaneous documentation and analysis that must be undertaken before filing a tax return. The amendments to the regulations, issued on July 5, 1994, do not change the degree of contemporaneous documentation that taxpayers must

prepare. There is, however, one significant revision that brings these regulations into closer conformity with the best method rule of final 482 regulations. In addition, there are disclosure requirements for the use of the profit-split or unspecified methods, as well as lump sum payments, that are not contained in the final 482 regulations.

The specified method requirement, which must be met for a taxpayer to qualify for the reasonable cause and good faith exception to penalties, has been modified. Under the amended temporary and proposed section 6662 regulations, a taxpayer has to reasonably conclude that the method and its application provides the most reliable measure of an arm's length result under the principles of the best method rule of reg. section 1.482-1(c). "A taxpayer can reasonably conclude that a method provides the most reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods consistent with the principles of the best method rule." /83/ Thus, the regulations determining whether penalties should be imposed under section 6662 reiterate the best method rule contained in the section 482 regulations. To avoid penalties, taxpayers must be able to explain how the best method was selected and why other possible methods were rejected.

Although the specified method requirement under section 6662 has been amended to be consistent with the standards elaborated in the final section 482 regulations, other proposed amendments to the section 6662 regulations contain requirements that extend beyond those in the final section 482 regulations. Specifically, tax return documentation in the form of a disclosure statement must be filed with the income tax return if the taxpayer applies a profit-split method; the consideration for the controlled transfer of an intangible is in the form of a lump sum payment; or an unspecified method is applied. /84/ The temporary section 482 regulations included requirements for taxpayers to disclose and document contemporaneously the use of "other" methods, and to make a binding election when the profit-split was used as an other method. The final section 482 regulations impose no such restrictions on profit split or unspecified methods other than that they satisfy the requirements of the best method rule and comparability standards. /85/ Thus, what the final section 482 regulations grant in terms of flexibility to use a profit-split or an unspecified method, the amendments to section 6662 restrict by requiring taxpayers to "flag" the use of such methods through a tax return disclosure. It should also be noted that with respect to lump sum payments, the disclosure must be made throughout the useful life of the intangible. /86/

The amended section 6662 regulations impose a reasonableness restriction on the choice of a point in the arm's length range. Specifically, the regulations state that if "the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived for the uncontrolled comparables, [s]uch a result would not likely be closest to an arm's length result." /87/ The regulations go on to note that one reasonable method of selecting a point in the arm's length range is to select the midpoint of the range (median or average). /88/ The other factors (experience and knowledge of taxpayer, cost of obtaining accurate data relative to the dollar amount of intercompany transactions, extent to which requirements of section 482 were followed, and the extent to which a taxpayer reasonably relied on the analysis of a professional) to be considered in assessing whether a taxpayer acted reasonably and in good faith have not been revised.

There were no amendments proposed to the section 6662 documentation requirements. Generally, the documentation requirements are that the taxpayer must be able to produce documents divided into two categories -- principal documents and background documents -- both of which must be in existence when the tax return is filed. The taxpayer also must provide this documentation to the IRS within 30 days of a request for it.

The amount of work required by taxpayers under the proposed section 6662 regulations to meet the reasonable and good faith exception is substantial. The requirements are typical of the type of information and analysis that would be prepared in applying the best method rule and comparability standards elaborated in the final section 482 regulations. Thus, it is through the requirements of the section 6662 regulations that taxpayers are required to substantiate that they have in fact done the necessary research and analysis of intercompany transactions to support their transfer pricing policies. The critical issues facing taxpayers will be the type and extent of transfer pricing analysis and documentation to prepare. Any analysis that does not address the standards of the specified or unspecified method requirements in a reasonable manner, or that does not satisfy the documentation requirements, leaves taxpayers with a risk of penalty. It is also important to note that the disclosure to the IRS of the use of profit-split or unspecified methods is now required under the section 6662 regulations to avoid penalties. Thus, failure to disclose the use of such methods only increases the likelihood of penalties if the adjustment thresholds are met.

XII. Reliance on Historical Data

Question 10: Can an analysis based on data from uncontrolled comparables from prior years be relied upon given the contemporaneous results orientation of the regulations?

Answer 10: Taxpayers should continue to use analysis based upon data from uncontrolled comparables from prior years but should carefully monitor all relevant data to ensure continued comparability and arm's length results.

Many taxpayers determine current and future transfer prices and prepare documentation based on budgeted data for the controlled taxpayers and on historical data for comparables. The final regulations stress the importance of comparing related-party transactions to data from contemporaneous uncontrolled transactions. In the context of establishing transfer prices in the current year and planning for prices over the next few years, taxpayers cannot accurately anticipate the results of either their intercompany transactions or uncontrolled transactions. Thus, a key issue arises as to how taxpayers can avoid (or minimize) both penalties and adjustments, given the inability to predict the outcomes of the controlled and uncontrolled transactions. Although the preamble to the 1993 temporary and proposed regulations asked for comments on the introduction of an exception to the regulations that would permit taxpayers to determine an arm's length result for a particular year by using data from uncontrolled comparables for prior years, the final section 482 regulations and the amended temporary section 6662 regulations do not contain any such provisions. /89/

If, in fact, based on actual company results and current data for the comparables, transfer prices or margins are outside the arm's length range, a taxpayer will need to assess the extent to which its results can be sustained as reasonable at the time of the transaction. While the IRS will have the benefit of hindsight in evaluating whether the results of related-party transactions meet the arm's length standard, there is some guidance in the regulations that can be used by taxpayers in determining whether the data and assumptions employed were reliable. If a taxpayer recognizes weaknesses in his forcast or analysis and before the filing of a tax return realizes that the results of intercompany transactions are not likely to be arm's length, the taxpayer can make an adjustment to its books and records or can account for differences on Schedule M. A Schedule M

adjustment recognizes that the position on a tax return does not conform to the financial books and records of a taxpayer. Thus, a taxpayer could adhere to the recommendations contained in a planning study issued before all relevant internal data became available through a "truing-up" mechanism in Schedule M. /90/

To the extent that a planning study relies on the most recent comparable data available, the results might still be considered reliable given the unavailability of data at the time of the transaction. That is, the regulations specifically state that ". . . if such data (data from the same years) is not available, reliable data from other years, as adjusted . . . may be used." /91/ Thus, a taxpayer might reasonably contend that prices were established using the most reliable available data. The regulations also point to the use of multiple year data to smooth out cyclical and other fluctuations.

To avoid the obsolescence of a planning study and to minimize the potential for discovering that actual data differs greatly from the arm's length range of results, monitoring of controlled transactions and comparables is required. The most important form of monitoring consists of persistent review of the functions and risks of the controlled parties to a transaction to insure that they correspond to the comparables. That is, if the facts and circumstances surrounding a controlled transaction change, the expected impact on the arm's length result must be evaluated. If the facts change, either adjustments should be made or new comparables sought. Similarly, the functions and risks of the comparables must be periodically examined to insure that they still correspond to the controlled parties. On an ongoing basis, however, the results of the comparables must be constantly updated. Thus, the financial results of the comparables should be updated and adjusted to more accurately match the time period and data of the controlled transactions.

XIII. Summary and Conclusions

Overall, the final regulations seem to respond effectively to many of the criticisms raised by taxpayers and foreign governments with respect to the temporary regulations. In particular, the role of the CPM has been reduced by providing more flexibility in the standards for comparables under other methods and easing the requirements for applying the profit-split method. Further guidance in applying the arm's length standard to intercompany services was not contained in the final

regulations and the 1968 regulations stand unchanged. Final cost-sharing regulations are still outstanding, as is a small taxpayer safe haven.

Although contemporaneous documentation of the application of the standards required under the final section 482 regulations is not generally required, if a taxpayer wants to be protected from penalties under section 6662, then extensive contemporaneous documentation must be prepared. Also, to avoid penalties under section 6662, if the profit-split or unspecified methods are applied, a disclosure statement must be filed with the tax return.

In reviewing the regulatory developments with respect to transfer pricing since the adoption of the commensurate-with-income standard, perhaps the most striking impression is that the final regulations compared with the 1992 proposed and 1993 temporary regulations provide taxpayers with flexibility that may approach that allowed under the 1968 regulations. In exchange for the return of this flexibility, however, the IRS requires that taxpayers consider the reasonableness of the application of the method through the detailed regulatory guidance provided under the best method rule, comparability, arm's length range, and other sections of the final regulations. This flexibility may imply greater controversy if taxpayers and revenue authorities disagree as to the choice of the best method and the application of unrelated-party data to controlled transactions.

FOOTNOTES:

/1/ Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder.

/2/ Section 482.

/3/ T.D. 6952, 1968-1 C.B. 218.

/4/ INTL-0372-88, INTL-0401-88, 57 FR 3571.

/5/ INTL-0401-88, 58 FR 5310.

/6/ U.S. Department of the Treasury and Internal Revenue Service, "A Study of Intercompany Pricing," Discussion Draft, Notice 88-123, 1988-2 C.B. 458. (Hereafter referred to as the White Paper.)

/7/ Reg. section 1.482-1(b)(1).

/8/ Reg. section 1.482-1(b)(1).

/9/ Reg. section 1.482-1(b)(1).

/10/ Reg. section 1.482-1(c)(1).

/11/ Reg. sections 1.482-1(d)(2), 1.482-3(b)(2)(ii), and 1.482- 4(c)(2)(ii).

/12/ Reg. section 1.482-1(d)(4)(i).

/13/ Reg. section 1-482-1(d)(4)(iii).

/14/ Reg. section 1.482-1(e)(2)(iii)(B).

/15/ Reg. sections 1.482-1(d)(3)(i) and 1.482-1(d)(3)(iii).

/16/ Internal Revenue Manual Audit Guidelines For Transfer Pricing Cases, dated June 14, 1994, exhibit 500-7 (MT 4233-45 6/14/94).

/17/ Reg. section 1.482-1(f)(2)(iii)(B).

/18/ Reg. section 1.482-1(f)(2)(iv).

/19/ Reg. section 1.482-1(g).

/20/ Reg. section 1.482-1(a)(3).

/21/ Reg. section 1.482-3((b) for the rules relating to the uncontrolled price method.

/22/ Reg. section 1.482-3(c) for the definition of the resale price method and its application.

/23/ Reg.section 1.482-3(d) for the definition of the cost plus method and its application.

/24/ Reg. sections 1.482-3(c)(3)(C) and 1.482-3(d)(3)(C).

/25/ Reg. section 1.482-3(e)(1).

/26/ Reg. section 1.6662-6T(d)(3)(iii)(C).

/27/ Reg. section 1.482-4(c) for the definition and application of the CUTM.

/28/ Reg. section 1.482-4(f)(2).

/29/ Reg. section 1.482-4(f)(2)(ii)(E).

/30/ Reg. section 1.482-4(f)(5).

/31/ Reg. section 1.482-7.

/32/ Reg. section 1.482-5(b)(1).

/33/ Reg. section 1.482-5(b)(2).

/34/ Reg. section 1.482-5(b)(4).

/35/ Reg. sections 1.482-5(c)(2)(iv) and 1.482-5(c)(3).

/36/ Reg. section 1.482-6(c)(2) for a general description of the comparable profit-split method and its application.

/37/ Notice 88-123, CB 458, October 18, 1988, pp. 94-98 (the White Paper).

/38/ Reg. section 1.482-6(c)(3)(i)(A).

/39/ Reg. sections 1.482-6(c)(3)(i)(B) and 1.482-6(c)(3)(ii)(B).

/40/ Reg. section 1.482-1(d)(2).

/41/ Reg. section 1.482-1(d)(3)(i).

/42/ Reg. section 1.482-1(d)(3)(iii)(A).

/43/ Reg. section 1.482-1(d)(3)(iii)(B).

/44/ Reg. section 1.482-1(e)(2)(ii).

/45/ Reg. section 1.482-1T(c)(2)(ii).

/46/ Reg. section 1.482-1(e)(2)(iii)(B).

/47/ Reg. section 1.482-1(d)(2).

/48/ Reg. section 1.482-1(d)(3)(ii)(B)(1).

/49/ Reg. section 1.482-5T(d)(2)(i).

/50/ Reg. section 1.482-1(e)(2)(i).

/51/ Reg. section 1.482-1(e)(2)(iii)(B).

/52/ Reg. sections 1.482-3(a) and 1.482-4(a).

/53/ Reg. section 1.482-1(c)(1).

/54/ Reg. section 1.482-1(c)(1).

/55/ Reg. section 1.482-1(c)(2).

/56/ Reg. section 1.482-8.

/57/ Reg. section 1.482-3(b)(2)(ii)(A).

/58/ Reg. preamble, p. 69.

/59/ Reg. section 1.482-5(b)(2)(i).

/60/ Reg. section 1.482-5(b)(2)(i).

/61/ Reg. section 1.482-5(c)(2)(ii).

/62/ Reg. section 1.482-5(c)(2)(i).

/63/ Reg. section 1.482-5(c)(3)(iii).

/64/ Reg. section 1.482-6(c)(2)(ii)((B)(1).

/65/ Reg. section 1.482-6(c)(2)(ii)(B)(1).

/66/ Reg. section 1.482-6(c)(3)(ii)(B).

/67/ Reg. section 1.482-6(c)(3)(ii)(D).

/68/ Reg. section 1.482-3(f).

/69/ Reg. section 1.482-3(b)(4) Example 2.

/70/ Reg. sections 1.482-3(c)(3)(ii)(B) and 1.482- 3(d)(3)(ii)(B).

/71/ Reg. section 1.482-3(c)(4) Example 4.

/72/ Reg. section 1.482-3(f).

/73/ Reg. section 1.482-4(f)(3)(i).

/74/ Reg. section 1.482-4(f)(3)(iv).

/75/ Reg. section 1.482-4(f)(2)(i).

/76/ Reg. section 1.482-4(f)(2)(ii)(A).

/77/ Reg. sections 1.482-4(f)(2)(ii)(B) and 1.482- 4(f)(2)(ii)(C).

/78/ Reg. section 1.482-4(f)(2)(ii)(D)(1).

/79/ Reg. section 1.482-4(f)(2)(ii)(E).

/80/ Reg. section 1.482-7.

/81/ See George Carlson, et al., "The Proposed New Transfer Pricing Rules: New Wine in an Old Bottle?" Tax Notes, Feb. 10, 1992, pp. 707-708, for a complete summary of the proposed cost-sharing regulations.

/82/ Reg. section 1.482-4(f)(5)(i).

/83/ Reg. section 1.6662-6T(d)(2)(ii).

/84/ Reg. sections 1.6662-6T(d)(2)(iii)(D) and 1.6662- 6T(d)(3)(iii)(C).

/85/ Reg. sections 1.482-3(e)(1), 1.482-6(c)(2)(ii) and 1.482- 6(c)(3)(ii).

/86/ Reg. section 1.6662-6T(d)(2)(iii)(D)(2).

/87/ Reg. section 1.6662-6T(d)(2)(ii)(E).

/88/ Reg. sections 1.6662-6T(d)(2)(ii)(E) and 1.482-1(e)(3).

/89/ Preamble to the 1993 temporary and proposed section 482 regulations.

/90/ Reg. section 1.482-1(a)(3).

/91/ Reg. section 1.482-1(f)(2)(iii)(A).

END OF FOOTNOTES

Table 1: THE EVOLUTION OF SECTION 482

[Table omitted]

DOCUMENT ATTRIBUTES

CODE SECTIONS	SECTION 482 -- TRANSFER PRICING
JURISDICTIONS	UNITED STATES
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