January 1994

The New Transfer Pricing Tax Regulations: Now That They're Here What Should You Do

Roland Davis

Follow this and additional works at: http://digitalcommons.law.scu.edu/chtlj

Part of the Law Commons

Recommended Citation
Available at: http://digitalcommons.law.scu.edu/chtlj/vol10/iss1/6
THE NEW TRANSFER PRICING TAX REGULATIONS: NOW THAT THEY'RE HERE WHAT SHOULD YOU DO?

Roland Ryan Davis†

TABLE OF CONTENTS

I. INTRODUCTION ....................................... 196
II. BACKGROUND INFORMATION .......................... 196
III. PENALTY PROVISIONS ................................ 197
IV. ADVANCED PRICING AGREEMENTS ................. 199
V. THE PROPOSED § 482 REGULATIONS ................. 202
   A. Matching Transaction Method .................... 203
   B. Comparable Adjustable Transaction Method .... 203
   C. Comparable Profit Method ....................... 204
   D. Comparable Profit Interval Method ............. 204
   E. Qualified Cost Sharing Arrangements .......... 206
VI. THE TEMPORARY § 482 REGULATIONS .............. 208
   A. Important Changes From The 1992 Proposed Regulations to the 1993 Temporary Regulations ... 208
   B. "Best Method" Rule ................................ 209
   C. Comparability ..................................... 210
   D. "Arm's Length" Standard ......................... 211
   E. Pricing Methods for Transfers of Property .... 212
      1. Comparable Uncontrolled Transaction Method 212
      2. Comparable Profits Method ................... 213
VII. NEW PROPOSED REGULATIONS ....................... 213
   A. Profit Split Method ................................ 213
   B. Foreign Legal Restrictions ...................... 214
VIII. IRS IMPROVEMENTS IN ADMINISTERING § 482 ISSUES ... 214
IX. COMPETENT AUTHORITY .............................. 215
X. CONCLUSION .......................................... 215
APPENDIX: LITIGATION OF § 482 ISSUES ............... 217
   1. Westreco, Inc. v. Commissioner ................. 217
   2. Procter & Gamble v. Commissioner ............. 218
   3. Exxon Corp. v. Commissioner ................. 219

Copyright © 1994 Roland Ryan Davis
† B.S., Santa Clara University; J.D., Santa Clara University School of Law, 1994. For the past five years, Mr. Davis has worked in international tax with a Big Six accounting firm.
I. INTRODUCTION

On January 13, 1993, the Internal Revenue Service (IRS) released a set of temporary regulations (1993 Temporary Regulations) on the issue of intercompany transfer pricing of tangible and intangible property. The transfer pricing rules apply to multinational companies and the way intercompany prices are established. The rules are intended to ensure that the price being charged between related parties is the same as it would be if the transaction were between unrelated parties. The IRS will impose severe penalties for failure to comply with these regulations.

Transfer pricing considerations are an important issue in the high technology area. Rapid advances in technology result in continuing changes in pricing strategy by corporations in order to compete effectively in the marketplace. Any tendency to ignore the tax implications of transfer pricing can be serious, particularly given the volume and high dollar value of high technology property that is transferred.

This comment will cover the penalty provisions of the 1993 Temporary Regulations, a discussion of advanced pricing agreements, important changes from the 1992 proposed regulations (1992 Proposed Regulations) in the 1993 Temporary Regulations (including a review of the 1992 Proposed and 1993 Temporary Regulations), along with suggestions on how to implement these new regulations and avoid substantial IRS penalties. The appendix discusses a few select transfer pricing cases.

II. BACKGROUND INFORMATION

From a business standpoint, an important issue that needs to be addressed is the tax consequences that arise from the intercompany transfer of property. Internal Revenue Code (hereinafter I.R.C.) § 482 deals with the intercompany transfer price attributable to both

---

2. For example, these regulations cover the price that is charged between a parent company and its subsidiary for the transfer of intangible (patents, copyrights, etc.) or tangible (disk drives, monitors, etc.) goods.
3. It has been suggested that significant tax dollars can be generated through the enforcement of transfer pricing regulations by focusing on foreign-owned multinational corporations as well as the U.S.-owned multinationals which have operations in low tax countries. Kathleen Matthews & Julianne MacKinnon, Practical Effects Of New Transfer Pricing Rules Dominate NYC Conference, 93 Tax Notes Int’l (Tax Analysts) at 69-6 (Apr. 12, 1993).
intangible and tangible goods. Recent legislation and case law in this area indicate an increased scrutiny by the IRS with regard to the pricing methodology applied to intercompany transfers of property.

The Tax Reform Act of 1986 revised I.R.C. § 482 to require that the consideration for the intercompany transfer of intangible property be based on a "commensurate with income" standard. This was followed in October 1988 by the issuance of a transfer pricing study, known as the "White Paper." Taxpayer comments on the White Paper were used to formulate proposed regulations.

The 1992 Proposed Regulations to I.R.C. § 482 were issued by the IRS on January 30, 1992. These regulations are the culmination of the IRS's continued effort to ensure that corporations are charging a fair amount for the transfer of goods (tangible or intangible) between "related parties."

The 1992 Proposed Regulations were retitled and released as the 1993 Temporary Regulations on January 21, 1993. Many organizations submitted comments and suggestions for revisions to the 1992 Proposed Regulations, which were considered by the IRS in preparing the 1993 Temporary Regulations.

III. PENALTY PROVISIONS

A significant series of proposed regulations covering the penalty provisions of I.R.C. § 6662(e) and I.R.C. § 6662(h) were issued along

6. [Allocation of Income and Deductions Among Taxpayers]: In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Id.

10. Related parties are companies that are members of the same controlled group (those that are controlled by the same interests). Temp. Treas. Reg. § 1.482-1A(a)(5)
12. Id. at 5265
The potential severity of the penalties is alarming. If the IRS makes transfer pricing adjustments of more than $5 million or 10% of the taxpayer’s gross receipts, a 20% penalty will be imposed. If the adjustments are more than $20 million or 20% of gross receipts, a 40% penalty will be imposed. However, these penalties will not be applied if the taxpayer can show that the transfer pricing method used is one indicated in the § 482 regulations, is reasonable, and is supported by “contemporaneous documentation.”

The phrase “contemporaneous documentation” means that the documentation the taxpayer uses to support the intercompany transfer price must be provided to the IRS within 30 days of an IRS request and must have been prepared prior to or at the time the tax return was prepared.

This contemporaneous documentation requirement is indicative of the prospective approach that needs to be undertaken in this area. Moreover, since high technology companies are in a rapidly developing industry, this contemporaneous approach to transfer pricing is a requirement that should not be overlooked. This may prove to be particularly cumbersome since new technology products are frequently released and the intercompany prices that are charged for them will therefore vary just as often. As a result, there may not be adequate documentation prepared to substantiate the transfer price charged.

To avoid a penalty in cases where the taxpayer does not use an indicated pricing method, the taxpayer must show that none of the methods in I.R.C. § 482 would clearly reflect income and that the method the taxpayer chooses does clearly reflect income. In addition, the taxpayer must still show reasonableness and contemporaneous documentation.

These penalty regulations were revised with the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 [hereinafter OBRA 1993], and apply to taxable years beginning after December 31, 1993. This article reflects those changes.
Another way a taxpayer can meet these criteria is with an advanced pricing agreement, which is discussed below.

Given the substantial penalties the IRS can assess for transfer pricing adjustments, it is important that taxpayers be aware of the correct methodologies to determine a transfer price the IRS will accept in this area. Taxpayers should therefore implement them as soon as possible. This issue cannot wait to be resolved at the time of an IRS audit, particularly since the documentation that is required must be prepared at the time the tax return is prepared.

One method of determining an adequate transfer price is to commission a transfer pricing study. This service is provided by accounting firms, economists and other consulting organizations. The benefit to engaging such a study is that it provides an objective opinion as to a reasonable transfer price. However, the cost of the study must be balanced with the benefit derived.

IV. Advanced Pricing Agreements

In conjunction with the penalty provisions in the 1993 Temporary Regulations, taxpayers should be aware of the advantages and disadvantages of an advanced pricing agreement (APA). These agreements allow taxpayers to obtain IRS approval of their transfer pricing methodology prior to an audit. Although this practice protects the taxpayer from exposure on an audit and the subsequent penalties that can arise, many companies may be hesitant to release the requisite detailed financial information. By entering into an APA, the taxpayer will be revealing information that will assist the IRS in understanding the intercompany pricing arrangement, but it could also alert the IRS to inconsistencies that may never have surfaced in the course of the regular audit process. However, this should be balanced against the risks that come from potential penalty assessments for those who choose to wait until they are audited.

On March 1, 1991, the IRS issued Revenue Procedure 91-22 which set out the method by which an advanced pricing agreement (APA) can be submitted to the IRS. An APA is an agreement be-

---

20. According to Harry L. Gutman, Chief of Staff of the Joint Committee on Taxation, "the goal of the section 482 provisions ... is to encourage ... (APAs), not to penalize taxpayers or force them to follow a formula." Becky Nagle, Foreign Tax Bill’s 482 Provisions Are to Promote APAs, Not to Punish, JCT Chief Says, 92 Tax Notes Today (Tax Analysts) at 229-1 (Nov. 16, 1992).

between the IRS and the taxpayer that covers the transfer price between two or more organizations, trades, or businesses that are directly or indirectly controlled by the same interests.\textsuperscript{22} Moreover, the agreement can also include a foreign competent authority as well as the IRS.\textsuperscript{23}

The approach to which the taxpayer must adhere is determined under the I.R.C. § 482 regulations.\textsuperscript{24} The proposed methodology "must be consistent with the arm's length standard" and "should produce, with as little adjustment as possible, an anticipated range of arm's length results that clearly reflect income."\textsuperscript{25} Absent any revisions in the prefiling conference, the following items must be submitted as part of the APA request:\textsuperscript{26}

1. The organizations, trades, businesses, and transactions that will be subject to the APA;
2. The names, addresses, telephone numbers, and taxpayer identification numbers of the controlled taxpayers that are parties to the requested APA (the parties);
3. A properly completed Form 2848 for any persons authorized to represent the parties in connection with the request;
4. A brief description of the general history of business operations, worldwide organizational structure, ownership, capitalization, financial arrangements, principal businesses, and the place or places where such businesses are conducted, and major transaction flows for the parties;
5. Representative financial and tax data of the parties for the last three years, together with other relevant data and documents in support of the proposed TPM [transfer pricing methodology] . . . ;
6. The functional currency of each party . . . ;
7. The taxable year of each party;
8. A description of significant financial accounting methods . . . ;
9. An explanation of significant financial and tax accounting differences . . . ;

\textsuperscript{22} Rev. Proc. 91-22 § 1.
\textsuperscript{23} This applies to international transfer pricing issues, for example, a transfer of technology from a U.S. parent company to a foreign subsidiary. The competent authority issues are discussed in part V.
\textsuperscript{24} Rev. Proc. 91-22 § 3.01.
\textsuperscript{25} Id. § 3.02. Taxpayers can also engage in prefiling conferences to clarify what data is required by the IRS. Id. § 4.
\textsuperscript{26} Each request and renewal costs $5,000. Id. § 5.14.
(10) A discussion of any relevant statutory provisions, tax treaties, court decisions, regulations, revenue rulings, or revenue procedures that relate to the TPM; and
(11) An explanation of the taxpayer’s and the government’s positions on previous and current issues at the examination, appeals, judicial, or competent authority levels (and any resolutions) that relate to the TPM.27

An APA request should also include the proposed term for the APA and any requests for competent authority considerations. The IRS may also require an independent expert opinion.28

Clearly the volume of information requested as a result of an APA will make many taxpayers hesitate. However, large multinational corporations may be able to benefit from an APA, particularly considering the dollar value of the transactions at stake.

Several companies have already begun the APA process,29 including Apple Computer,30 General Motors, Barclays Bank PLC, Sumitomo Bank Capital Markets, Inc., and Matsushita, the Japanese conglomerate.31 An example of the potential penalty assessments is the Matsushita case, in which the IRS assessed approximately $3 million in taxes for overcharging on video-cassette recorders from 1981-1982. Although the case has since been settled, the IRS is still auditing the firm’s U.S. subsidiary for later years.32

27. Id. § 5.03.
28. Id. § 8.01.
29. As of March 1993, there were approximately 45 taxpayers involved in the APA process and 36 taxpayers were “considering” entering the process. GULC/NFTC Conference Paper On APAs By IRS Director Of APA Program, Robert Ackerman, 93 Tax Notes Int’l (Tax Analysts) at 51-11 (Mar. 17, 1993).
30. Apple’s request filled three loose leaf binders. Mary Louise Dionne & Mike Urse, IRS Issues Advance Pricing Agreement (APA) Guidance, Tech. Tax Spotlight Libr. (Int’l Tax Serv.) at 91-7 (Apr. 15, 1991). Apple also has voluntarily entered into a binding arbitration case with the IRS over transfer pricing issues between Apple Computer, Inc. and its subsidiary Apple Singapore with regard to the income earned in Singapore for Apple’s printed circuit board and system manufacturing. Although a decision was reached on September 3, 1993, the details were not made public. Arbitration Panel Reaches Decision On Apple Computer Section 482 Adjustment, Daily Tax Rep. (BNA) at G-4 (Sept. 10, 1993).
31. Announced November 10, 1992 (Matsushita Electric Announces APA With IRS, NTAA On Transfer Pricing, Daily Tax Rep. (BNA) at G-5 (Nov. 12, 1992)); A company spokesman stated that “In light of the complex nature of [cross-border, bilateral] taxation and enormous work and legal costs involved, we concluded that it is better to use the advanced pricing agreement.” Id. As an example of the effect that these I.R.C. § 482 regulations are having on Japanese companies, a December 1991 survey by the Federation of Economic Organizations of Japan, which is Japan’s largest economic lobby, revealed that out of 328 companies, 107 stated that they were anticipating having disputes with the IRS. Furthermore, 47 firms stated that within the last five years, they have had disputes with the IRS regarding transfer pricing issues. Id. at G-6.
32. Id.
Despite the assurance of submitting an APA, there is still the problem that many companies either do not have the information requested readily available, or more importantly, do not want the IRS to have access to audit information prior to an actual audit. These concerns must be balanced against the benefit of avoiding the penalty and interest assessments that could result from an audit.

Another concern of taxpayers contemplating an APA is the time it takes to get an APA approved. The IRS estimates that the APA process takes an average of nine to twelve months for each case. Although this may seem to be a long period of time, it is substantially shorter than the 15-24 month period it takes to perform an audit and the additional time spent on appeal. Costs to the taxpayer should also not be much more than what would be incurred on an audit, although initial costs would be higher. It is also important to keep in mind that the APA process should be carefully considered in the high technology area due to the rate at which products become obsolete.

The release of the 1993 Temporary Regulations does not affect Revenue Procedure 91-22. Therefore, advanced pricing agreements continue to be an important avenue for taxpayers to consider when addressing intercompany transfer pricing issues.

V. The Proposed § 482 Regulations

The following section examines the proposed regulations that were released on January 30, 1992. Although the temporary regulations have been released, an understanding of the proposed regulations is necessary since some of the concepts mentioned have been retained in the new regulations.

The most significant change in the 1992 Proposed Regulations over previous law is that the original 1968 regulations regarding transfers of intangibles were replaced. The standard to be applied with respect to intangibles is the “arm’s length standard,” which states that the “consideration for the intangible shall be commensurate with the

---


34. Id.

35. [Intangible:] (1) Patents, inventions, formulas, processes, designs, patterns, or knowhow; (2) Copyrights; (3) Literary, musical, or artistic compositions; (4) Trademarks, trade names, or brand names; (5) Franchises, licenses, or contracts; (6) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; (7) Other similar items; and (8) Any interests in such items.

income attributable to the intangible.” 36 This “commensurate with income” standard is an important concept that is carried throughout the transfer pricing regulations.

The intangible transfer must also be in an appropriate form. The 1992 Proposed Regulations states that “if the transferee pays nominal or no consideration for an intangible . . . the arm’s length consideration shall be in the form of a royalty unless a different form is clearly more appropriate.” 37

There are three prescribed methods in the 1992 Proposed Regulations for determining the arm’s length price: the matching transaction method (MTM), the comparable adjustable transaction method (CAT), and the comparable profit method (CPM). 38 This is also the strict order of priority that is given to each method. The taxpayer must first try to apply the MTM, then the CAT, and finally the CPM. The taxpayer is not required to demonstrate that the higher priority method or methods do not apply, but the highest priority method appropriate to the transaction must be applied. 39

A. Matching Transaction Method

A matching transaction is one that is the “same or substantially similar” in both economic conditions and contractual terms as the intangible being transferred. 40 In other words, the uncontrolled transfer must be an identical match to the intangible transaction to which it is being compared. Given the significant and particular requirements that need to be met for a transaction under this method, it is unlikely that many taxpayers will be able to use the MTM. This is particularly true since intangibles tend to be unique, as are the contractual terms by which they are transferred.

B. Comparable Adjustable Transaction Method

The CAT is used when the MTM does not apply. This method is applied when the intangible property transferred is the same as or similar to the intangible with which it is being compared. Under this method, the economic conditions and contractual terms are considered adjustable only if they are “sufficiently similar [so] that the effect . . . can be determined with reasonable accuracy.” 41 However, if the prof-

36. Id. § 1.482-2(d)(1)(i).
37. Id. § 1.482-2(d)(2)(ii).
38. Id. § 1.482-2(d)(1)(iii).
39. Id.
40. Id. § 1.482-2(d)(3)(i).
41. Id. § 1.482-2(d)(4)(ii).
its of the taxpayer are not within the comparable profit interval (CPI) then the transaction will not be considered to be at arm's length. The CPI, discussed below, is the range of profits that uncontrolled parties have in similar economic functions.

C. Comparable Profit Method

This third method is applied if the MTM and the CAT cannot be used to determine a proper arm’s length price. Under this method, the “reported operating income”\(^4\) is compared to the comparable profit interval to establish an acceptable transfer price. If the reported operating income falls within the CPI, the transfer price will generally be considered to be at arm’s length.\(^4\) If it does not, an adjustment may be made by the IRS to bring it to the “most appropriate point within the \(\text{CPI}\).”\(^4\) This is determined by considering all the facts and circumstances in the case.\(^4\)

D. comparable Profit Interval Method

The CPI method is used to compute an arm’s length transfer price when the MTM does not apply. It is therefore used in applying the CAT or the CPM. The CPI determines whether the profit earned by the taxpayer is within a certain profit range of similar firms performing similar tasks. The regulations set out six steps in determining a comparable profit interval:\(^4\)

1. Select the party to a controlled transaction to be tested. The selected party does not have to be the one that is under audit. An example given in the 1992 Proposed Regulations posits that the CPI of a foreign subsidiary may be selected even if the U.S. parent is the entity under review.\(^4\) The tested party will be the one with the most accurate data and the “most accurately quantifiable data.”\(^4\) Furthermore, the regulations state that the transferee will ordinarily be the tested party when reviewing the transfer of intangibles.\(^4\)

42. Reported operating income is defined as the operating income reported on a timely filed (or amended) U.S. income tax return before an audit by the IRS has commenced. Id. § 1.482-2(d)(5)(v).
43. Id. § 1.482-2(d)(5)(ii).
44. Id. § 1.482-2(d)(5)(iii).
45. Id. § 1.482-2(d)(8).
46. Id. § 1.482-2(f).
47. Id. § 1.482-2(f)(4).
48. Id. § 1.482-2(f)(4)(ii).
49. Id.
2. **Determine the applicable business classification of the tested party.** There are two steps to determine the applicable business classification: (1) Identify the operations of the tested party with respect to the intercompany transactions; and (2) Match the tested operations to uncontrolled entities that have similar operations.\(^5\) Tested operations are defined as operations that are "related to or integrated with the transactions with controlled parties that are under review."\(^5\) This is based on the products, functions and services performed.

3. **Compute constructive operating incomes.** "Constructive operating income is derived by applying profit level indicators computed from uncontrolled taxpayers to financial data of the tested party."\(^5\) The uncontrolled taxpayers should be similar to the taxpayer under review. Some similarities that should be considered are the size of the business and the relative markets served.

   Profit level indicators are also selected to compute the constructive operating profits. The profit level indicators can be any of the following: rate of return on assets, margins (operating income/sales, gross income/operating expenses, operating income/labor costs, operating income/expenses-cost of goods sold), and comparable profit splits (residual profit split\(^5\) and overall profit split\(^5\)).\(^5\)

4. **Determine the comparable profit interval.** The determination under this step requires that the constructive operating incomes of the comparable uncontrolled taxpayers be

---

\(5\) Id. § 1.482-2(f)(5)(i).

\(5\) Id. § 1.482-2(f)(5)(ii).

\(5\) Id. § 1.482-2(f)(6)(i).

\(5\) Under the residual profit split, income attributable to assets is determined by applying a rate of return to the value of assets held by the uncontrolled taxpayers. This amount then is subtracted from the operating income of each such uncontrolled taxpayer to yield the residual income. The sum of the uncontrolled taxpayers' residual incomes is the residual combined income. The profit split is the percentage of the residual combined income earned by each uncontrolled taxpayer. This profit split is then applied to the tested party to calculate its constructive operating income. The same rates of return that were applied to the uncontrolled taxpayers are applied to the assets of the group of controlled taxpayers and the resulting amount then is subtracted from the combined operating income of the group of controlled taxpayers. The residual combined income then is apportioned among the group of controlled taxpayers in the same percentages that were determined for the uncontrolled taxpayers.


\(5\) "Under the overall profit split, the group of controlled taxpayers' profit split is determined in the same manner as under the residual profit split, but without first providing a return on assets." Id. § 1.482-2(f)(6)(iii)(C)(3)(ii)(B).

\(5\) Id. § 1.482-2(f)(6)(iii)(C).
constricted so that any extreme divergences are eliminated in computing the comparable profit interval.  

5. **Determine the most appropriate point in the comparable profit interval.** The most appropriate point in the interval is the cluster of similar firms that are included in the computation of the interval.  

6. **Determine the transfer price for the controlled transaction.** The final step is calculating the transfer price. This price should generate an operating income that equals the constructive operating income at the most appropriate point in the interval. If the constructive operating income falls within the interval, the IRS will not make any adjustment; if it does not, then the transfer price will be adjusted so that it falls within the interval.  

E. **Qualified Cost Sharing Arrangements**

A qualified cost sharing arrangement is defined as an arrangement involving two or more participants that provides for the sharing of the costs (including direct and indirect costs) and risks of developing an intangible in return for a specific interest in the produced intangible.  

The cost sharing arrangement must include an identification of the participants, the duration, the intangible development area(s) covered, the method for dividing costs of developing intangibles, the extent to which any tangible or intangible property not developed under the arrangement is made available to participants, the extent to which non-participants are allowed to use the intangible, the nature of any exclusive rights, any conditions under which the arrangement can be modified or terminated, and the general administrative provisions of the arrangement. The purpose of these provisions is to set out con-  

56. Id. § 1.482-2(g)(7).  
57. Id. § 1.482-2(g)(8).  
58. Id. § 1.482-2(g)(9).  
59. Id. § 1.482-2(g)(10)(A)-(E).  
60. U.S. participants are defined as “any eligible participant of a cost sharing arrangement whose income or earnings may be relevant for U.S. federal income tax purposes. Thus, for example, a ‘U.S. participant’ includes a controlled foreign corporation as defined in [I.R.C. § ] 957.” Id. § 1.482-2(g)(7)(iii).  
61. Id. § 1.482-2(g)(7)(ii).  
62. The requirements for cost sharing arrangements are set out as follows: “(A) The material provisions of the arrangement are recorded in writing contemporaneously with the formation of the cost sharing arrangement; and (B) Any change to a material provision of the arrangement is recorded in writing and is reported [on the income tax return, Form 5471 or Form 5472 filed by participant].” Id. § 1.482-2(g)(6)(i).  
63. Id. § 1.482-2(g)(6)(iii).
tractually the method by which the benefits and burdens are to be shared between the contracting parties.

The costs and risks of development must be reasonably allocated between the participants in the cost sharing agreement. There is a presumption of unreasonableness if the taxpayer's cost/income ratio is "grossly disproportionate" to that of others in the participating group. However, the taxpayer can rebut this presumption by proving that the approach used is reasonable. If this ratio is found to be disproportionate, the IRS will deem a transfer of the intangible beyond that contemplated by the arrangement. This transfer will be subject to the buy-in and buy-out provisions to determine the arm's length price. Buy-in and buy-out payments can take the form of a lump sum payment, installment payments, or royalties.

The cost/benefit analysis used to determine a cost sharing arrangement can be measured by anticipated units of production (where there is a uniform unit of production), anticipated sales (measured at the same level of the production or distribution process for all participants), anticipated gross or net profit, or any other reasonable measure. Furthermore, adjustments to the cost sharing must be made, generally on an annual basis, to reflect any changes in economic conditions or business operations of the participants, and for the continuing development of intangibles specified in the arrangement.

The IRS has the discretion to make allocations on a qualified cost sharing arrangement if it determines that the arrangement is not broad

---

64. The cost/income ratio of a U.S. participant is the average of the cost of developing intangibles borne by the participant divided by the participants average operating income attributable to intangibles developed under the arrangement. The cost/income ratio of other participants is the sum of the other participants' average costs divided by the sum of their average operating incomes attributable to the intangibles developed under the arrangement. [These averages are computed by] using the average from the current taxable year and the two preceding taxable years.

65. "A U.S. participant's cost/income ratio not will be considered substantially disproportionate if it is less than twice the cost/income ratio of the other eligible participants." Id. § 1.482-2(g)(2)(ii)(C)(2).

66. Id. § 1.482-2(g)(2)(ii)(C)(1).

67. "The portion of the intangible deemed to have been transferred will be measured by the difference between the U.S. participant's cost/income ratio and the cost/income ratio of the other eligible participants." Id. § 1.482-2(g)(4)(ii)(C).

68. Id. § 1.482-2(g)(4)(iv).

69. Id. § 1.482-2(g)(4)(ii)(C).

70. Id. § 1.482-2(g)(4)(iv)(B).

71. Id. § 1.482-2(g)(2)(ii).

72. Id. § 1.482-2(g)(2)(ii)(B).
enough to cover related intangible development\textsuperscript{73} or that the development of the products or services will not be used in the active conduct of a trade or business.\textsuperscript{74}

VI. The Temporary § 482 Regulations

The 1993 Temporary Regulations are a significant change from the 1992 Proposed Regulations. The 1992 Proposed Regulations were released in proposed form, which means they were not effective until released as temporary and then finalized. The purpose of the 1992 Proposed Regulations was to solicit taxpayer responses and suggestions in the intercompany transfer pricing area.

The 1993 Temporary Regulations replace the 1992 Proposed Regulations.\textsuperscript{75} The 1993 Temporary Regulations became effective 90 days after they were published in the Federal Register\textsuperscript{76} and supersede the previous regulations (1968 Regulations). If the 1993 Temporary Regulations are finalized within three years, they will permanently replace the 1968 Regulations.\textsuperscript{77} However, the 1968 Regulations will become effective again if the 1993 Temporary Regulations are not finalized within the three year time period.\textsuperscript{78}

A. Important Changes From the 1992 Proposed Regulations to the 1993 Temporary Regulations

Several changes were made in the 1993 Temporary Regulations as a result of taxpayer commentary to the 1992 Proposed Regulations. Some of the important changes were the priority of methods, profit splits, periodic adjustment with respect to the transfer of intangibles, and the availability of a \textit{de minimis} exception.

The priority of methods in the 1992 Proposed Regulations emphasized that the matching transaction method (MTM) was the highest method to be applied followed by the comparable adjustable transaction method (CAT) and the comparable profit method (CPM). The

\textsuperscript{73} Id. § 1.482(g)(4)(i)(A). "For this purpose, consideration will be given to the participant's prior business practices, the business practices of uncontrolled taxpayers in the same or related businesses, and the three-digit Standard Industrial Classification code which includes such products or services." Id. § 1.482(g)(4)(i)(B).

\textsuperscript{74} Id. § 1.482-2(g)(4)(i)(C).

\textsuperscript{75} Some sections of the 1992 Proposed Regulations were re-released as proposed regulations at the same time as the 1993 Temporary Regulations. 58 Fed. Reg. 5310 (1993). For an analysis of the new proposed regulations, see part VII below.

\textsuperscript{76} Temp. Treas. Reg. § 1.482 (1993). The 1993 Temporary Regulations were published on January 21, 1993 and are effective for taxable years beginning after April 21, 1993.

\textsuperscript{77} 58 Fed. Reg. 5263 (1993)

\textsuperscript{78} Id.
1993 Temporary Regulations introduces the “best method” rule.\textsuperscript{79} This rule focuses on a “facts and circumstances” test, depending on the accuracy of the data used and how closely the controlled and uncontrolled transactions are comparable.\textsuperscript{80}

The profit split approach in the 1992 Proposed Regulations was perceived as difficult to implement. These sections were re-released in proposed form in January 1993 and are available only for certain transactions.\textsuperscript{81}

Periodic adjustments are required under both the 1992 Proposed Regulations and the 1993 Temporary Regulations. The 1992 Proposed Regulations required that the taxpayer review its intercompany transactions annually and make an adjustment if the new price did not fall within the comparable price interval (CPD).\textsuperscript{82} The approach in the 1993 Temporary Regulations states that the annual adjustment must be commensurate with income, which is not necessarily the same as the CPI.

The 1993 Temporary Regulations include a \textit{de minimis} exception that was not contained in the 1992 Proposed Regulations. This exception applies to companies that have less than $10 million in aggregated sales revenue.\textsuperscript{83} Election for this exception is made by filing a statement attached to the taxpayers U.S. income tax return.\textsuperscript{84}

\textbf{B. “Best Method” Rule}

These new regulations are a substantial improvement in several respects. For example, they include new concepts such as the “best method” rule.\textsuperscript{85} This “best method” rule supersedes the hierarchy of pricing methods in the proposed regulations. It came about as a result of the numerous comments, like those by the American Electronics Association, that taxpayers submitted which suggested a more flexible approach to pricing methodologies.\textsuperscript{86}

The “best method” rule of the regulations states that the arm’s length result should be determined by the “most accurate measure of

\textsuperscript{79} Id. § 1.482-1T(b)(2)(iii)(A).
\textsuperscript{80} Id.
\textsuperscript{84} Id. § 1.482-1T(f)(1)(iv).
\textsuperscript{85} Id. § 1.482-1T(b)(2)(iii)(A).
\textsuperscript{86} \textit{Id.}.
an arm’s length result under the facts and circumstances of the transaction.” 87 Factors that determine the best method are: the completeness and accuracy of the data used, the degree of comparability between controlled and uncontrolled transactions, and the number, magnitude, and accuracy of the adjustments required to apply each method. 88

From the taxpayers’ standpoint, an important factor to focus on is the comparability issue. This is because finding comparable uncontrolled transactions will still be difficult for producers of unique goods, such as companies in the high technology field.

C. Comparability

The new regulations include comparability factors which are used in comparing controlled transactions to uncontrolled transactions. 89 The factors are: functional analysis, analysis of risk, contractual terms, economic conditions, and property and services. 90 There are also provisions for market share considerations and location savings. 91 Each factor is discussed below.

The functional analysis is based on finding comparable transactions between entities that have similar functions. The functions considered are: “research and development; product design and engineering; manufacturing or process engineering; product fabrication, extraction and assembly; purchasing and materials management; marketing and distribution functions . . .; transportation and warehousing; and managerial, legal, accounting and finance, credit and collection, training, and personnel management services.” 92

The risk factor 93 is discussed at length in the 1993 Temporary Regulations, although it was not mentioned in the 1992 Proposed Regulations. This analysis focuses on the risk assumed in relation to the transaction, by comparing the risk assumed by a controlled taxpayer to the risk assumed by an uncontrolled taxpayer. Some of the risk factors considered are: “market risks including the fluctuations in cost, demand, pricing, and inventory levels; risks associated with the success or failure of research and development activities; financial risks including fluctuations in foreign currency rates of exchange and inter-

88. Id.
89. Id. § 1.482-1T(c)(1)(i).
90. Id. § 1.482-1T(c)(3)(i)-(v).
91. Id. § 1.482-1T(c)(4)(i)-(ii).
92. Id. § 1.482-1T(c)(3)(i).
93. Id. § 1.482-1T(c)(3)(ii).
est rates; credit and collection risks; product liability risks; and general business risks.\textsuperscript{94}

The controlled taxpayer must also have contractual terms that are comparable to those of an uncontrolled taxpayer.\textsuperscript{95} This is an important feature to consider because it affects the way businesses analyze their intercompany agreements. Intercompany agreements determine the allocation of income and expenses between related parties. Companies should review their agreements to assess any potential allocation problems that could arise as a result of an IRS audit.

Economic conditions must also be factored into the comparability evaluation.\textsuperscript{96} Some of the economic conditions are: realistically available alternatives to the buyer and seller, the similarity of geographic markets, the relative size of each market and the extent of economic development, the level of the market, the market shares for the items transferred or provided, location of specific costs, and competition in the market.\textsuperscript{97}

The 1993 Temporary Regulations also include provisions for market share factors and locations savings.\textsuperscript{98} These regulations state that the savings achieved from being in an economical locality may be shifted to an entity not in that locality to compensate for the competitive factors.\textsuperscript{99} This comparability standard is less stringent than the standard imposed by the Proposed Regulations because transactions do not need to be exactly comparable, but rather need only to be "sufficiently similar."\textsuperscript{100} As discussed, adjustments may be made to the transactions to compensate for inherent differences between controlled and uncontrolled transactions.

In sum, the comparability analysis focuses on an analysis of the facts and circumstances of each case. This is a more flexible approach than suggested in the Proposed Regulations.

D. "Arm’s Length" Standard

According to the regulations, the "arm’s length" standard is to be followed in a controlled transaction.\textsuperscript{101} The purpose of the "arm’s

\begin{itemize}
\item \textsuperscript{94} Id.
\item \textsuperscript{95} Id. § 1.482-1T(c)(3)(iii).
\item \textsuperscript{96} Id. § 1-482-1T(c)(3)(iv).
\item \textsuperscript{97} Id.
\item \textsuperscript{98} Id. § 1.482-1T(c)(4)(i)-(ii).
\item \textsuperscript{99} Id. § 1.482-1T(c)(4)(i).
\item \textsuperscript{100} Id. § 1.482-1T(c)(2)(i).
\item \textsuperscript{101} Id. § 1.482-1T(b)(1). "The ‘arm’s length result’ of a controlled transaction is the amount of consideration that would have been charged or paid (or the profits that would have been earned) in comparable transactions between uncontrolled taxpayers." Id.
\end{itemize}
length” standard is to place controlled taxpayers on a “tax parity” with uncontrolled taxpayers through the assessment of the controlled taxpayers “true taxable income.”

The regulations also introduce the new concept of an “arm’s length range.” This is similar to the comparable profit interval provisions in the 1992 Proposed Regulations. As long as the taxpayer’s income falls within this “arm’s length range,” the IRS will not make adjustments. However, if the income is outside of the range, the IRS can make adjustments that “ordinarily will be to the midpoint of the range.”

This new “arm’s length range” is an important concept for taxpayers to consider when reviewing comparable transactions because these transactions will be determinative of the range.

E. Pricing Methods for Transfers of Property

The 1993 Temporary Regulations discuss three methods of pricing property transfers: (1) the comparable uncontrolled transaction method (CUT), (2) the comparable profits method (CPM), and (3) other methods.

1. Comparable Uncontrolled Transaction Method

The CUT is similar to methods contained in the 1992 Proposed Regulations. As a result of taxpayer comments, the 1993 Temporary Regulations have combined the MTM and the CAT into the CUT. This new method is not tested under the CPI as was required under the 1992 Proposed Regulations. In conjunction with the “best method” rule, the CUT should generally be the most accurate arm’s length result. Therefore, CUT can be used to establish the arm’s length range.

Under the CUT, the form of compensation for the transaction must be similar to that found in a comparable uncontrolled transaction. Moreover, intangible transfers can be evaluated on an annual basis to determine whether the intangible price meets with the “com-

102. Id. § 1.482-1T(a)(1).
103. Id. § 1.482-1T(d)(2)(i).
104. Id. § 1.482-1T(d)(2)(i)(A).
105. Id. § 1.482-1T(d)(2)(i)(C).
106. Id. § 1.482-4T(a). A fourth method, using profit split, is discussed in proposed regulations issued with the 1993 Temp Regs. See part VII(A) below.
107. Id. § 1.482-4T(e)(1).
108. Id.
109. Id. § 1.482-4T(e)(1).
mensurate with income" standard. If conditions have changed such that the pricing of the intangible no longer reflects an arm's length result, an adjustment must be made. This annual adjustment is certain to be heavily criticized by taxpayers as an undue burden.

2. Comparable Profits Method

The CPM in the 1993 Temporary Regulations is substantially similar to the CPM discussed in the 1992 Proposed Regulations. One notable difference is that the CPM is no longer a required test of the other comparable pricing methods. However, relative profit levels between controlled transactions and uncontrolled transactions will be considered as part of the comparability analysis.

The CPM will generally be applicable for transactions "unless the [taxpayer] uses valuable, non-routine intangibles that itself (1) acquired from uncontrolled taxpayers . . . or (2) developed itself." In addition, the CPM will be applied on an "industry segment" basis and only after adjustments have been made under the I.R.C. § 482 regulations.

The arm's length result considered under the CPM is determined by using a single profit level indicator rather than several indicators as indicated in the 1992 Proposed Regulations. The profit level indicators used under this method are (1) return on capital employed, (2) ratio of operating profit to sales, and (3) ratio of gross profit to operating expenses. The Regulations also allow other reasonable measures to be used.

VII. New Proposed Regulations

A. Profit Split Method

In conjunction with the 1993 Temporary Regulations issued on January 13, 1993, a new set of Proposed Regulations were issued regarding profit split methods. The new proposed methods include: (1) residual allocation rule (RA), (2) capital employed allocation rule

110. Id. § 1.482-4T(e)(2)(i).
111. Id.
112. Id. § 1.482-5T.
113. Id. § 1.482-5T(a).
114. Id.
115. Id. The definition of "non-routine" is absent from the regulations.
117. Id. § 1.482-5T(b)(2).
118. Id. § 1.482-5T(e)(1)-(2).
119. Id. § 1.482-5T(e)(3).
The new proposed methods supersede the previously issued 1992 Proposed Regulations on profit split methods.

B. Foreign Legal Restrictions

Proposed regulations covering foreign legal restrictions on payments between controlled taxpayers were also released. Under these regulations, the IRS will recognize the restrictions if: (1) the restrictions are publicly promulgated and apply to similarly situated taxpayers; (2) the taxpayer has exhausted all effective and practical remedies for obtaining a waiver of the restrictions; (3) the restrictions prevent the payment or receipt of the arm’s length price; and (4) the taxpayer has not engaged in any transaction which has the effect of circumventing the restriction (i.e. distributing a dividend).

Moreover, the taxpayer must elect the deferred method of accounting as specified in I.R.C. § 461. Essentially, this means deductions relating to blocked income can only be claimed in the year that the income can be included on a U.S. tax return. Companies in this situation will have an additional burden to track these expenses separately (blocked expenses vs. non-blocked expenses). This is particularly applicable to high technology companies that have significant research and development expenditures. Since these regulations are still in proposed form, comments will be considered before they are re-issued as temporary regulations.

VIII. IRS Improvements in Administering § 482 Issues

Another I.R.C. § 482 consideration is the implementation by IRS officials of several methods to improve the administration of I.R.C. § 482 cases. The administrative focus is on the following: centralizing the cases so that there is a standard approach, developing detailed audit guidelines to assist IRS agents in assessing these cases, and coordinating communication between the IRS counsel’s office and the Examination Division which will assist in litigation of § 482 issues. These issues should be carefully followed. In fact, assistant IRS commissioner Frances Homer has stated that these administrative items

121. Id. § 1.482-6T(c)(1).
122. This issue was raised in Procter & Gamble v. Commissioner, 961 F.2d 1255 (6th Cir. 1992), as discussed in the appendix.
124. Id.
will be more important to taxpayers than the regulations themselves.\textsuperscript{126}

IX. **COMPETENT AUTHORITY**

The U.S. has negotiated numerous tax treaties with foreign countries to provide relief from double taxation. The “competent authority rules” permit taxpayers to request the U.S. competent authority to attempt to resolve any issues with the foreign country competent authority. But such a request is exactly that; the competent authority can refuse the request.

In resolving any transfer pricing issues, the U.S. competent authority\textsuperscript{127} will apply I.R.C. § 482 and the underlying regulations. In so doing, the competent authority will also consider the facts and circumstances of each case.\textsuperscript{128}

The IRS is attempting to reduce the time to settle tax issues with treaty partners by engaging in personal negotiations. Although the time has been reduced from five years to two since 1991, the IRS believes it can be further improved. Currently, IRS officials meet with the Canadian competent authority every quarter and with all other treaty partners every six months.\textsuperscript{129}

X. **CONCLUSION**

Previously, companies would wait until an IRS audit before looking at these transfer pricing issues. Under the regulations as now drafted, companies will be required to take a position with respect to property transfers on a yearly basis at the time their tax returns are being prepared. Companies will now have to take a *prospective approach* rather than a retrospective approach. Considering the stiff penalties which could be imposed, this prospective strategy can save companies significant sums of money.

When addressing intercompany transfer pricing on a prospective basis, companies should consider the viability of transfer pricing studies. These studies consist of an in-depth, economic and financial analysis, and are performed by a variety of consulting firms. These are

\begin{footnotesize}
\begin{enumerate}
\item[126.] Id.
\item[127.] The U.S. competent authority is the Assistant Commissioner (International) and is responsible for administering, interpreting and applying these treaties. Rev. Proc. 91-23 § 2.04, 1991-1 C.B. 534
\item[128.] Rev. Proc. 91-23 § 3.03.
\end{enumerate}
\end{footnotesize}
generally highly involved exercises and would apply primarily to medium to large multinational corporations.

The complexity and significance of these intercompany transfer pricing regulations is not to be ignored. The new regulations affect many facets of technology companies and any implications that they have should be dealt with prior to an IRS audit. For larger companies, it may be advisable to seek an APA to reduce the risks of the penalty provisions. Smaller companies may be able to benefit from the safe harbor provisions. For companies somewhere in between, it is advisable to review operations and engage in a transfer pricing study to assess any potential tax exposure.
APPENDIX: Litigation of § 482 Issues

Discussed below are selected cases that have been litigated on transfer pricing issues.\textsuperscript{130} They are illustrative of the court holdings in this area and the dollar amounts that are at stake.\textsuperscript{131}

1. Westreco, Inc. v. Commissioner

In Westreco, Inc. v. Commissioner,\textsuperscript{132} the IRS attempted to allocate fee income to Westreco because it determined that the fees paid by Nestec (a Swiss subsidiary of Nestle, S.A.) to Westreco did not clearly reflect income pursuant to I.R.C. § 482.\textsuperscript{133} In this instance, Westreco is a U.S. subsidiary of Nestec which contracted to perform research and development activities on behalf of Nestec and Nestle.\textsuperscript{134} Westreco was responsible for the development and improvement of new products and processes.\textsuperscript{135} As compensation for performing these R & D services, Nestec paid Westreco on a cost plus basis. In this contract, Nestec was to reimburse Westreco for certain expenses\textsuperscript{136} plus a 7.5% profit on the first $350,000 of expenses, 5% on the next $1,500,000 and 3.5% of any additional expenses.\textsuperscript{137}

The IRS issued a deficiency notice to Westreco in which the IRS reallocated total fees of $19,515,542 from Nestec to Westreco for the period from 1978-1982.\textsuperscript{138} The IRS used a multiplier method to determine this amount. However, at the trial, the IRS offered no evidence to support this calculation but rather based its determination on comparable business data.\textsuperscript{139} The court held that Westreco proved that the allocations made by the IRS were defective and that Westreco sus-
tained the burden of proof with respect to the reasonableness of their approach. This signalled yet another defeat for the IRS in a transfer pricing case.

2. Procter & Gamble v. Commissioner

The Procter & Gamble v. Commissioner\(^{141}\) appellate decision affirmed the holding of the Tax Court that found the allocation of income to Procter & Gamble from its wholly owned subsidiary was inappropriate. In this case, Procter & Gamble A.G. (AG), a Swiss corporation, entered into a License and Services Agreement with its U.S. parent, Procter & Gamble (P&G).\(^{142}\) The agreement provided that AG would pay royalties to P&G "for the nonexclusive use by AG and its subsidiaries of P&G's patents, trademarks, tradenames, knowledge, research and assistance in manufacturing, general administration, finance, buying, marketing and distribution."\(^{143}\)

AG organized a subsidiary in Spain, P&G Espana S.A. (Espana), with the understanding that under Spanish law it was a crime to make payments from Spanish entities to foreign countries without express government approval.\(^ {144}\) This restriction was lifted in 1985 when Spain joined the European Economic Community. As a result, Espana began to pay royalties to AG.\(^ {145}\)

The IRS determined that two percent of Espana's net sales should be allocated as royalty payments to AG for 1978 and 1979.\(^ {146}\) This resulted in an increase of AG's income by $1,232,653 in 1978 and $1,795,005 in 1979.\(^ {147}\) The Tax Court held that this redetermination of income was improper because the royalty payments were restricted under Spanish law and not by P&G.\(^ {148}\)

Because of a lack of conflict among the circuits, the IRS has chosen not to seek review by the Supreme Court.\(^ {149}\) Interestingly, the

---

\(^{140}\) Id. at 30-31.

\(^{141}\) Procter & Gamble v. Commissioner, 961 F.2d 1255 (6th Cir. 1992).

\(^{142}\) Id. at 1256.

\(^{143}\) Id.

\(^{144}\) "The Spanish government approved P&G's application for 100 percent ownership in Espana by a letter dated January 27, 1968. The letter expressly stated that Espana could not, however, pay any amounts for royalties or technical assistance." Id. at 1257.

\(^{145}\) Id.

\(^{146}\) Procter & Gamble, 961 F.2d at 1257. The years in question were before the payment ban was lifted.

\(^{147}\) Id.

\(^{148}\) Id. at 1258.

\(^{149}\) IRS Won't Petition High Court on Foreign Issue in 'Procter & Gamble', Source Says, Daily Tax Rep. (BNA) at G-1 (Nov. 9, 1992).
concerns in this case have been factored into the drafting of the 1993 Temporary Regulations and is discussed in part VII, above.

3. *Exxon Corp. v. Commissioner*

In *Exxon Corp. v. Commissioner*,\(^{150}\) which was filed after the *Procter & Gamble* decision, the petitioners argued that the holding in *Procter & Gamble* should apply in the situation where Saudi Arabia restricted the price on crude oil. The court ruled that Exxon’s profits could not be reallocated under I.R.C. § 482 or § 61 (gross income).\(^ {151}\) The tax deficiencies sought by the I.R.S. in this case were in excess of $6 billion.\(^ {152}\)

4. *Bausch & Lomb v. Commissioner*

In *Bausch & Lomb v. Commissioner*,\(^ {153}\) the deficiency assessed by the IRS reflected the IRS contention that there was a lack of arm’s length pricing between Bausch & Lomb, Inc. (B&L) and Bausch & Lomb Ireland, Ltd. (B&L Ireland). In January of 1981, B&L and B&L Ireland entered into a non-exclusive license agreement to manufacture lenses.\(^ {154}\) The IRS reallocated income from B&L Ireland to B&L by applying I.R.C. § 482 principles.\(^ {155}\) The reassessment for 1981 was an additional $2,359,331 and $18,425,750 for 1982.\(^ {156}\) The Tax Court found these amounts unreasonable and reduced the amounts to $1,255,331 for 1981 and $4,173,000 for 1982.\(^ {157}\) The appellate decision affirmed the Tax Court holding.\(^ {158}\)

\(^{150}\) Exxon Corp. v. Commissioner, T.C. Memo 1992-92, 63 T.C.M. (CCH) 2067 (1992)

\(^{151}\) Id. at 1087.

\(^{152}\) Id. at 1086.

\(^{153}\) Bausch & Lomb v. Commissioner, 933 F.2d 1084 (2d Cir. 1991).

\(^{154}\) Id. at 1087.

\(^{155}\) Id.

\(^{156}\) Id. at 1086.

\(^{157}\) Id.

\(^{158}\) Bausch & Lomb, 933 F.2d at 1086.