REPORT #738

TAX SECTION

New York State Bar Association

COMMENTS ON PROPOSED SECTION 482 AND
COST SHARING REGULATIONS

October 22, 1992

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OFFICERS
JOHN A. CORRY
Chair
450 Lexington Avenue
New York City 10117
212/530-4608

Tax Report #738

TAX SECTION

New York State Bar Association

October 23, 1992

The Honorable Fred T. Goldberg, Jr.
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Room 3120
Washington, DC 20220

Dear Assistant Secretary Goldberg:

Please find enclosed a report which comments on the regulations proposed earlier this year on intercompany transfer pricing and cost sharing under Internal Revenue Code section 482.[1]

The report commends the Service for acknowledging that there is not a single arm's length price to be utilized in applying section 482 and for attempting to formulate a more systematic approach for determining transfer prices.

The report recommends, however, that the comparable profit interval ("CPI") that, under the proposed regulations, would become the

[1] This report was prepared by an Ad Hoc Committee chaired by Elliot Pisem, Stanley I. Rubenfeld and Mary Kate Wold and consisting of: Reuven Avi-Yonah, Thomas A. Bryan, James P. Constantino, Edward A. Demblitz, Alan 0. Dixler, Robert Feinschreiber, Gary M. Friedman, Seth B. Goldstein, Alan W. Granwell, Todd G. Helvie, Deborah Jung Jacobs, Raymond D. Jasen, Michael Loenig, Robert J. McDermott, Pinchas Mendelson, Wayne P. Merkelson, Anthony P. Polito, Rene C. Schlag, Lawrence E. Shoenthal, David R. Tillinghast, Steven C. Todrys, Gene Vogel and Philip R. West.

The report was drafted by: Alan W. Granwell, Deborah Jung Jacobs, Elliot Pisem, Philip R. West and Mary Kate Wold.

Helpful Comments were received from: William L. Burke, Peter C. Canellos, John A. Corry, Peter L. Faber, Arthur A. Feder, Richard O. Loengard, Jr., Charles M. Morgan III and David E. Watts.nn primary method for determining the transfer price for both intangible and tangible property, should be utilized, if at all, as either another method or an elective safe harbor. We reached this conclusion because we believe that making CPI mandatory would not be in conformance with Compliance 2000 or the 1992 Business Plan since taxpayer compliance with, and IRS administration of, CPI would be extremely burdensome and complex and would require a vast amount of uncontrolled taxpayer data, subjective judgments and retention of experts.

The report recommends that the proposed regulations should be modified to permit the use of a profit split analysis, particularly in cases where both related parties have valuable intangibles. Rules as to when the matching transaction method applies to the transfer of intangible properties should be relaxed. With respect to the transfer of tangible property and/or services, either the final regulations should not cause the intangible rules to apply at all, or at the very least, such application should be narrowly construed.

The report also recommends devoting substantial effort to perfecting the cost-sharing rules. In our view, those rules can provide a major benefit to both taxpayers and the Treasury.

Finally, the report strongly urges the Service to promulgate rules that correspond more closely to the rules utilized by our trading partners. Otherwise, potentially irreconcilable disputes are likely to arise which would result in international double taxation.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

John A. Corry
Chair

Identical Letter Sent to:

The Honorable Shirley D. Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 20224

cc: Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longsworth House Office Building
Washington, DC 20515

Abraham N.M. Shashy, Jr., Esq.
Chief Counsel Internal Revenue Service
Room 3026
1111 Constitution Avenue, N.W.
Washington, DC 20224

Alan J. Wilensky, Esq.
Deputy Assistant Secretary
of the Treasury for Tax Policy
3108 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Robert E. Culbertson, Esq.
Associate Chief Counsel (International)
Internal Revenue Service
Room 3052 CC: Int'l
1111 Constitution Avenue, N.W.
Washington, DC 20224

Charles S. Triplett,
Deputy Associate Chief Counsel
Office of the Associate Chief Counsel (Int'l)
Internal Revenue Service
Room 3052 CC: Int'l
1111 Constitution Avenue, N.W.
Washington, DC 20224

John T. Lyons
Assistant Chief Counsel
Office of the Associate Chief Counsel (Int'l.)
Internal Revenue Service
Room 4617
1111 Constitution Avenue, N.W.
Washington, DC 20224

Kenneth W. Wood
Senior Technical Reviewer
Office of the Associate Chief Counsel (Int'l.)
Branch 1
Internal Revenue Service
950 L'Enfant Plaza South, SW
Room 3319
Washington, DC 20224

Edualdo daSilva
Industry Economist
Office of the Associate Chief Counsel (Int'l.)
Internal Revenue Service
Room 4575
1111 Constitution Avenue, N.W.
Washington, DC 20224

Lisa G. Sams
Attorney Advisor
Office of the Associate Chief Counsel (Int'l.)
Internal Revenue Service
Room 4712
1111 Constitution Avenue, N.W.
Washington, DC 20224

Sim Seo
Attorney Advisor
Office of the Associate Chief Counsel (Int'l.)
Branch 2
Internal Revenue Service
Room 4704
1111 Constitution Avenue, N.W.
Washington, DC 20224

Thomas L. Ralph
Attorney Advisor
Office of the Associate Chief Counsel (Int'l.)
Branch 6
Internal Revenue Service
Room 4607
1111 Constitution Avenue, N.W.
Washington, DC 20224

James R. Mogle
Acting International Tax Counsel
Office of the International Tax Counsel
Department of the Treasury
1500 Pennsylvania Ave., N.W. - Room 3064
Washington, DC 20220

Warren Crowdus
Attorney Advisor
Office of the International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 3064
Washington, DC 20220

Barbara Rollinson
Acting Director
Office of the International Tax Staff
Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 5117
Washington, DC 20220

T. Scott Newlon
International Economist
Office of the International Tax Staff
Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 5117
Washington, DC 20220

Tax Report #738

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMENTS ON PROPOSED SECTION 482 AND COST SHARING REGULATIONS

October 22, 1992

This report (the "Report")[1] comments on regulations on intercompany transfer pricing and cost sharing proposed on January 30, 1992,[2] under section 482[3] (the "proposed regulations"). The proposed regulations are intended to implement the commensurate with income standard, which was added to section 482 by the Tax Reform Act of 1986 (the "TRA"). Under that standard, income with respect to the transfer of an intangible is required to be commensurate with the income attributable to the intangible.[4]

INTRODUCTION

Section 482 authorizes the Internal Revenue Service (the "Service") to make allocations between related parties to prevent the avoidance of tax or to clearly reflect income. The only significant change to the language of the statute since its inception more than 70 years ago, was the addition in 1986 of the

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1 This report was prepared by an Ad Hoc Committee chaired by: Elliot Pisem, Stanley I. Rubenfeld ana Mary Kate Wold and consisting of: Reuven Avi-Yonah, Thomas A. Bryan, James P. Constantino, Edward A. Dembitz, Alan O. Dixler, Robert Feinschreiber, Gary M. Friedman, Seth B. Goldstein, Alan W. Granwell, Todd G. Helvie, Deborah Jung Jacobs, Raymond D. Jasen, Michael Loening, Robert J. McDermott, Pinchas Mendelson, Wayne P. Merkelson, Anthony P. Polito, Rene C Schlag, Lawrence E. Shoenthal, David R. Tilnnghast, Steven C Todrys, Gene Vogel and Philip R. West

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2 57 Fed. Reg. 3571 (1992), as corrected in 57 Fed. Reg. 27716 (1992).

3 All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the income tax regulations promulgated thereunder.

4 § 482

requirement that income from the transfer or license of intangible property be commensurate with the income attributable to the intangible. To implement this change, the proposed regulations contain detailed new rules for applying the commensurate with income standard to the transfer of intangible property between controlled parties, and to cost sharing arrangements. In addition, the proposed regulations apply the commensurate with income standard to transfers of tangible property between-controlled parties and also modify certain of the general rules of application of the current section 482 regulations.

In the past, taxpayers were not as concerned with exposures under section 482. Regulations under section 482 were viewed principally as a compliance tool of the Service rather than as a planning tool for taxpayers.[5] Transfer pricing however, has now moved to the forefront of concern for multinationals for many reasons. Because of the large amount of revenue at stake, the Service is emphasizing and has committed enormous resources to transfer pricing issues and examinations.[6] Today, if the Service is able to sustain a proposed allocation, the resulting exposure not only includes the tax and interest[7] attributable to the allocation, but also can include significant penalties.[8]

5 A taxpayer is free to establish its transfer pricing under any methodology that it chooses. Section 482 is utilized by the Service to “police” controlled transactions to assure they comport with arm’s length standards. Thus, section 482 is a tool of the Service rather than of taxpayers. See Reg. § 1.482-1(b)(3).

6 See Statement of Shirley D. Peterson before the Subcommittee on Oversight, House Ways and Means Committee, Hearing on Tax Underpayments by U.S. Subsidiaries of Foreign Corporations, April 9, 1992. (“Peterson Testimony”)

7 Under the “hot interest” provision of section 6621(c), there is a two percent increase in the interest rate imposed on larger underpayments of tax by corporations.

8 § 6662(a).

Therefore, if the proposed regulations are finalized, they will assume a prominent position in planning. Related taxpayers, in structuring their transactions, most likely will attempt to conform their transfer pricing to methodologies sanctioned under the regulations so as to be in the best position possible to defend their pricing in the event the Service were to question the transaction and to avoid the imposition of potentially severe penalties under section 6662(a). This is appropriate since, as expressed in the preamble to the proposed regulations, a basic objective of the proposed regulations is to facilitate transfer pricing by taxpayers in ways that will lead to less controversy with the Service and, similarly, to facilitate determinations by the Service of appropriate arm's length pricing.

The promulgation of the proposed regulations is also viewed by the Service as consistent with its initiative known as Compliance 2000. A central feature of this initiative is to increase voluntary compliance and to reduce the burden on taxpayers. As stated in its Report on the Application and Administration of Section 482, "in the section 482 arena, the proposed section 482 regulations and the Advance Pricing Agreement ("APA") program illustrate the IRS commitment to encouraging voluntary compliance."[9] The provision of "simple, practical and user friendly guidance" has also become a main theme of the Treasury Department and the Service in the context of its 1992 Business Plan.[10]

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9 Department of the Treasury, Internal Revenue Service, Report on the Application and Administration of Section 482, at 6-1 (April, 1992) ("IRS § 482 Report").

10 See Treasury News, Treasury Department and IRS Announce 1992 Business Plan (May 15, 1992). The Business Plan contemplates that final regulations or other guidance will be provided under section 482.

In the Committee’s view, the principles underlying Compliance 2000 and the 1992 Business Plan should be taken into account in evaluating the proposed regulations. Further, in the Committee’s view, it is essential that the proposed regulations be compatible with international transfer pricing norms, which are based on the arm’s length standard; otherwise, taxpayers applying the regulations could become subject to international double taxation.

A summary of our principal comments and recommendations on the proposed regulations is set forth in the following section. Our detailed comments and recommendations follow.

SUMMARY OF PRINCIPAL COMMENTS AND RECOMMENDATIONS

Principal Comments

From a broad policy perspective, the proposed regulations in principle continue to affirm the primacy of the arm’s length standard. The proposed regulations acknowledge that there is not a single arm’s length price; rather^ there can be a range of arm’s length prices, and in establishing that range, it is appropriate to use a multi-year analysis to deal with business cycles. Moreover, the proposed regulations provide that if the taxpayer’s pricing is just outside of the range, the Service generally will make a commensurate adjustment to bring such pricing within the range. The Committee commends the Service for stating these positions. The Committee also commends the Service for attempting to formulate a more systematic approach for determining transfer prices. In this regard, the Committee recognizes that prescribing rules to determine arm’s length transfer pricing is not an easy task, particularly in the many situations where third- party comparables are not available, and that there is a perception (which may or may not be valid) that taxpayers are able to manipulate the existing rules to their unfair advantage. However, in the absence of third-party comparables, other principled approaches, consistent with international norms, should be provided to allocate the appropriate amount of income from the controlled transaction among the participants to the transaction by reference to the value that each participant adds to the transaction, in a manner that is susceptible to practical derivation and audit and which is consistent with international norms.

The proposed regulations do not easily accommodate establishing the existence of an exact comparable, either with respect to the transfer of intangible or tangible property (i.e., a matching transaction in the case of intangible property and a comparable uncontrolled transaction in the case of tangible property). Moreover, even though the proposed regulations seek to permit the utilization of inexact comparables (i.e., a comparable adjustable transaction in the case of a transfer of intangible property and a resale price or cost plus method in the case of tangible property), those methods can only be used if the operating income of the controlled taxpayer resulting from application of the method is validated by satisfying yet another test, namely, the comparable profit interval (the “CPI”). In practice, utilization of the CPI becomes the primary method for determining the transfer price for both intangible and tangible property.

The CPI is a methodology which determines transfer pricing by reference to the profits an uncontrolled taxpayer earns from dealing with third parties through reference to activities that should but may not necessarily be similar to those of the controlled taxpayer being tested in the controlled transfer. This approach is intended to implement the profits-based standard of the commensurate with income standard and to deal with the lack of third-party comparables.

The Committee believes that the CPI should not be adopted as the mandatory standard for validating (or in certain cases determining) transfer prices for intangible and tangible property in cases where an exact comparable does not exist The CPI may nonetheless play an important role in the transfer pricing area. The reasons for our position are as follows:

- The CPI approach is a radical departure from the current approach for determining transfer prices. That approach primarily involves identifying the functions undertaken, assets utilized, risks incurred in the controlled transaction and, by reference to a "functional analysis," locating comparable third-party transactions against which to judge the controlled transaction. The difficulty with the current approach is the lack of third- party comparables, especially in cases involving high-profit intangibles, and the resort to a variety of "ad hoc" approaches. In an attempt to avoid such difficulties, the Service has proposed a methodology to determine arm's length pricing by reference to the profitability of uncontrolled parties engaging in uncontrolled transactions. On its face, this does not seem unreasonable, as the profitability of the parties and comparable third-parties are factors taken into account in structuring and auditing transfer pricing currently. Upon closer examination, however, this methodology may not necessarily reflect the actual income which should be attributable to each of the parties in the controlled transaction under review because it is based solely on the profitability of uncontrolled taxpayers which may not be in the same situation as the controlled taxpayer being tested. Although the CPI attempts to incorporate a functional analysis in its construction, it may be constructed from financial data of uncontrolled taxpayers which in many cases will not be in the same circumstances as the tested party under review. Accordingly, there can be no assurance that the CPI will reflect an amount that should be earned with respect to the value added by the tested party to the controlled transaction, let alone clearly reflect the amounts that should be earned by the other controlled taxpayers to the transaction. Thus, in our view, to rely solely on the profitability of uncontrolled taxpayers and not take into account the controlled taxpayer's specific circumstances will cause the CPI approach not to clearly reflect the income of the controlled parties to the transaction.

- Uncontrolled party transfer pricing is market driven. A similar standard should apply to controlled party transfer pricing. Under the proposed regulations, however, controlled party transfer pricing in large part will require conformance with the levels of profitability earned by uncontrolled taxpayers who may not be in similar circumstances. This does not seem correct. Although the Committee recognizes a certain amount of tax inquiry is required in controlled situations, regulations should not be promulgated which deviate so substantially from establishing transfer pricing by reference to market factors.

- In order to construct the CPI, access to a vast amount of uncontrolled taxpayer data both in the United States and abroad will be required. At this point in time, it is not clear how much useful U.S. data is available, let alone data from abroad. Although the Committee is aware that the Service, together with other government agencies, organizations and taxpayers, is studying the availability and accessibility of data, the Committee is concerned that the data required to perform the CPI will not be easily accessible. In that event, the practical usability of the CPI as the primary method of the proposed regulations will be diminished.

- Even if sufficient data is available, virtually every step in the development of the computation of the CPI requires the taxpayer and the Service to make subjective decisions with respect to which the proposed regulations provide little, if any, guidance. To utilize a system that is intended to minimize the areas of controversy, but which in its application contains numerous ambiguities, and allows for more subjectivity rather than less, has the effect of merely shifting, rather than resolving, the current areas of controversy and is not consistent with the primary objectives underlying promulgation of the proposed regulations.

- To construct and apply the CPI will be burdensome. It is not clear to the Committee how large corporate taxpayers with numerous intercompany transactions involving thousands of products will be able to attempt to comply with the proposed regulations without devoting a disproportionate amount of resources to that end. It is also unclear how the large universe of smaller taxpayers who engage in cross-border controlled party transactions will be able to deal with the CPI requirements or, for that matter, how the Service will be able to effectively audit these transactions. These concerns must be addressed before the Service promulgates final regulations.

- The complexity inherent in complying with the proposed regulations in most if not all cases will force controlled taxpayers to retain or hire experts such as economists, statisticians and tax professionals to assist in structuring or defending transfer prices within the rules of the proposed regulations. Having tax rather than business persons be the principal persons determining transfer pricing should not be encouraged as it departs from economic reality. The Committee believes that regulations should not be promulgated which virtually force taxpayers to hire outside advisors to assist in complying with the requirements of the regulations and which superimpose tax over business considerations.

- In enacting the commensurate with income standard, Congress was mainly concerned with transfer pricing abuses related to high-profit intangibles. It is not clear to the Committee why the CPI should apply to many types of transactions not involving high-profit intangibles and for which, in the Committee's view, there is no need to apply the CPI. The Committee believes that the current rules relating to transfer pricing should not be superseded by the CPI, especially where the current rules appear to work well enough in areas not involving high-profit intangibles.

- In the view of the Committee, the CPI does not conform with the legislative history to the commensurate with income standard, particularly because it utilizes a profitability standard which could be viewed as representing an industry average.

- The Committee believes that the proposed regulations, by their nature, will not reduce the burden on taxpayers and, for the reasons set forth above, in practice will not be simple, practical or user-friendly. Thus, they are not in conformance with the precepts of Compliance 2000 or with the principles of the 1992 Business Plan. We strongly urge the Service to attempt to comport with the objectives and principles of Compliance 2000 and the 1992 Business Plan.

- The Committee believes that the CPI and the application of the intangible and tangible property rules of the proposed regulations are not in conformance with international norms. If this is the case, unilateral application of the proposed regulations by the United States will at a minimum lead to difficulties with our trading partners and most likely also will result in international double taxation. These difficulties are likely to hinder the competitiveness of U.S. multinational corporations and exacerbate existing difficulties with our trading partners which could lead to retaliation.

Recommendations

Our primary recommendations are as follows:

- In view of the standard of section 482, controlled party transfer pricing should be market (and not tax) driven. Accordingly, the CPI should not be the mandatory system for determining transfer prices. Instead, the validity of transfer prices should be determined based on facts and circumstances, of which the CPI is but one factor.

Thus, if the CPI mechanism is to be retained, it should be either another method or an elective safe harbor. If ft is retained as another method, it should be based on data for the three years prior to the year of transfer and have a lower priority of application. If it is adopted as an elective safe harbor, to the extent that a taxpayer’s income from the transfer of intangible or tangible property falls within the CPI (as agreed upon by the taxpayer and the Service), determined for the three years prior to the year of transfer, then such taxpayer’s transfer pricing methodology should not be subject to challenge by the Service. On the other hand, if a taxpayer’s income from the transfer of intangible or tangible property is not within the CPI for the three years prior to the year of transfer, then, as under any other method, such taxpayer's transfer pricing could be challenged by the Service, though, as under any other method, the taxpayer would have the opportunity to rebut such challenge.

- The Service should modify the proposed regulations to permit the use of a profit split analysis, particularly to deal with cases where both related parties have valuable intangibles. In applying a profit split methodology, the taxpayer would be required to justify how it apportioned profits by reference to the circumstances of the transaction in order to respond to the concerns of the Service. We recognize the benefit of objective guidelines and welcome the opportunity to work with the Service in their development

- The rules as to when the matching transaction method applies to the transfer of intangible property should be relaxed. The comparable adjustable transaction method and the comparable profit method should be retained, but the twelve factor test of the current regulations also should be available to be utilized by taxpayers with the modification that actual profits from the transfer of intangibles be the predominant (but not the sole determining) factor in determining the transfer price. The priority of application rules of the proposed regulations should be retained and the recommended twelve factor test method should be viewed as another method below the matching transaction method and the comparable adjustable transaction method.

- With respect to transfers of tangible property, the CPI should not be mandated to be utilized in connection with the application of the resale and cost plus methods. Similar to our suggestion with respect to intangibles, however, the CPI either could be a “fourth method” or an elective safe harbor in connection with the application of the resale price or cost plus methods. With respect to the application of so-called “fourth methods,” the CPI could be a method, but there should not be a requirement that income resulting from transfer pricing utilizing that or another methodology be at the most appropriate point of the interval. Instead, if the income falls within the interval, it would also constitute use of an appropriate method or be eligible for the safe harbor described above. If it falls outside of the interval, the Service, as with other methods, could challenge the methodology, subject to rebuttal by the taxpayer. Moreover, the rule that permits the Service to limit adjustments should apply not only to transfers of intangible property, but also to transfers of tangible property.[11]

- Either the final regulations should not cause the intangible rules to apply to the transfer of tangible property and/or services or, if they are to apply at all, the circumstances should be very narrowly construed, as is described below.

- In conjunction with the foregoing recommendations, consideration should be given to crafting special rules and/or safe harbors for small taxpayers and for transactions not incorporating high-profit intangibles.

- The Committee strongly urges the Service to promulgate rules that correspond more closely to the rules utilized by our trading partners. Otherwise, potentially

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[11] Under this rule, if a tested party’s income falls just outside of the CPI, the Service in its discretion may limit the adjustment to just within the CPI and not to the most appropriate point

irreconcilable disputes could arise which would result in international double taxation.

- As a general matter, the Service should consider proposing rules dealing with currency fluctuations in the context of transfer pricing.

- The Committee commends the Service for having adopted the APA approach. It is a significant advancement in the effort to resolve transfer pricing disputes, since APAs are particularly useful for hard cases not dealt with specifically by regulatory guidance, e.g., global trading. The Committee further commends the Service for the practical approach the Service has taken in considering and processing APAs and urges the Service to continue its commitment to the APA process. Further, the Committee recommends that Revenue Procedure 91-22 be modified to the extent necessary to reflect changes made in the proposed regulations when they are finalized

- The Committee suggests that when the proposed regulations are finalized, in an effort to reduce compliance burdens, careful consideration should be given to coordinating the substantive rules of the regulations with the recordkeeping, reporting and record production rules of section 6038A and 6038C and the regulations promulgated thereunder. The Committee further recommends that there be similar close coordination with regulations to be promulgated under section 6662(a). In that regard, the Committee recommends that the section 6662(a) regulations provide that a taxpayer that structures its pricing according to a method contained in the regulations when finalized and contemporaneously documents its efforts, will be deemed to have satisfied the reasonable cause provisions of that section.

- We believe that Service adjustments to a taxpayer's cost share or to the scope of the intangible development area covered by a cost sharing arrangement should be allowed only if a taxpayer is determined not to be an "eligible participant" in a "qualified cost sharing arrangement" and that no Service adjustments should be allowed otherwise. The Committee also believes that a taxpayer should not be required to use an intangible in the active conduct of a trade or business to be an "eligible participant" in a cost sharing arrangement Additionally, we believe that the periodic adjustment requirement should be eliminated from the definition of a qualified cost sharing arrangement and that the presumption of disqualification of a cost sharing arrangement where cost/income ratios are grossly disproportionate also should be eliminated. Finally, the Committee believes that if the final regulations retain the concept of distinguishing between types of adjustments that the Commissioner may make, the "proportionate profits rule" should be based, in appropriate cases, on measures of an intangible's benefit to a taxpayer other than income.

* * *

The Committee recognizes that the Service has devoted substantial effort and resources to promulgating the proposed regulations and the Committee gratefully acknowledges such effort The Committee is also encouraged by recent statements of Treasury representatives indicating that there may be more modifications in the proposed regulations to reflect taxpayer comments. The Committee stands ready to assist the Service in any way it can in the further consideration of the matters covered by the Report

The Committee's technical comments and recommendations are set forth below.

DETAILED COMMENTS AND RECOMMENDATIONS

Section 1.482-1(b)

Summary of Proposed Regulations

The current regulations provide that the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[12]

The proposed regulations clarify how the foregoing determination should be made. They provide that in determining whether controlled taxpayers have dealt with each other at arm's length, the general guiding principle is whether uncontrolled taxpayers would have agreed to the same terms, given the actual circumstances under which the controlled taxpayers dealt[13] For this purpose, uncontrolled taxpayers are deemed to exercise sound business judgment on the basis of reasonable levels of experience (or, if greater, the actual level of experience of the controlled taxpayer) within the relevant industry and with full knowledge of the relevant facts.[14] In applying the general principle, the Service is given discretion in two specific areas to look to the substance, rather than the form, of the transaction. First, it may consider the combined effect of all transactions of a controlled taxpayer with other members of the group, as well as

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12 Reg. § 1.482-1(b)(1).

13 Prop. Reg. § 1.482-1(b)(1).

14 Id.

with uncontrolled taxpayers, before, during, and after the taxable year under review.[15] For example, the Service could integrate the license of an intangible to a related party and the sale of tangible property (produced by using the technology of the transferred intangible) by the related party to the licensor.[16] The Service also may disregard the absence or presence of contractual arrangements between controlled taxpayers and instead consider the actual conduct of the parties.[17] For example, the Service could disregard the absence of a contract between related parties in determining that, based on the facts, one of the parties is a contract manufacturer.[18]

Comments

The above summarized proposed regulations' refinement of the principles for determining arm's length prices would appear to be an attempt by the Service to reverse losses it has sustained in the courts and to make it more difficult for a taxpayer to rebut a section 482 allocation proposed by the Service.[19] The proposed regulations' provision that uncontrolled taxpayers are deemed to exercise sound business judgment could be interpreted as an attempt by the Service to bolster its position that the Service may override a controlled taxpayer's business judgment with its own. This is an argument which has been often

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15 Id.

16 Id.

17 Id.

18 Id.

19 A section 482 allocation is presumed to be correct unless the taxpayer can show that it was arbitrary, capricious or unreasonable. In addition, even if the taxpayer can prove the foregoing, it is necessary for the taxpayer to prove that its transfer pricing was arm s length.

made by the Service in section 482 cases and one which repeatedly has been rejected by the courts.[20]

The grant of discretion to the Service to consider the combined effect of all transactions is a restatement of the Service's round-trip argument in Bausch & Lomb v. Commissioner:[21] Contrary to the Service's argument, the court found that the price received for tangible property and the royalty paid for intangible property, by the same party, had independent significance.[22] The proposed regulations' grant of authority to the Service to disregard the absence or presence of contractual relationships could be interpreted as an attempt by the Service to provide support for its contract manufacturing argument, rejected in both Bausch & Lomb and Sundstrand Corp.

Under current law, in applying the arm's length standard, the transactions of controlled taxpayers are compared to those of uncontrolled taxpayers entered into for sound business reasons.[23] Accordingly, the proposed regulations' statement of principle to that effect adds nothing to the law or the application of the current regulations and is unobjectionable on its face. However, to the extent that the statement of principle is intended to give the Service authority to substitute its business judgment for the taxpayer's, it should be modified explicitly to eliminate any such authority.

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[20] See Procter & Gamble Co. v. Comm'r, 95 T.C. 323 (1990), affd, (6th Cir. 1992); EU Lilly & Co. v. Comm'r, 84 T.C. 996 (1985), rev'd in part, affd in part and remanded, 856 F2d 855 (7th Cir. 1988); Bush Hog Mfg. Co. v. Comm'r, 42 T.C 713 (1964); Polack's Frutal Works, Inc. v. Comm'r, 21 T.C. 953 (1954).

[21] 933 F2d 1084 (2d Cir. 1991), affg 92 T.C. 525 (1989).

[22] See also Sundstrand Corp. v. Comm'r, 96 T.C. 204 (1991).

[23] See, e.g., G.D. Searle & Co. v. Comm'r, 88 T.C. 252,270 (1987).

With respect to the provisions that the Service may consider the combined effect of transactions and may disregard the presence or absence of contractual arrangements, the intended effect is unclear. To the extent that the provisions merely are intended to be a restatement of the principle that the substance of transactions govern over their form for transfer pricing purposes, they are unobjectionable, though somewhat limiting in that they deal only with two examples of that broad principle. In fact, a regulatory statement with respect to substance over form would appear to be unnecessary because courts in the past have looked to the substance of a transaction in applying section482.[24] If the foregoing is the intent of the provisions, the proposed regulations could be clarified to so provide.

On the other hand, to the extent that the provisions are intended to grant the Service even broader authority to recharacterize bona fide transactions and relationships, the Committee views them to be invalid. That a taxpayer is free to select the way in which it carries on its business and has the right to arrange its affairs to achieve maximum tax savings is fundamental.[25] Likewise, where the substance and the form of a transaction are identical, the courts have not permitted the Service to recharacterize the transaction as one which never in fact occurred.[26] It has long been recognized that "[s]ection 482 is not designed to punish the mere existence of commonly

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24 See, e.g., Merck & Company, Inc. v. United States, 24 C1 Ct 73 (1991). See also Bausch & Lomb v. Comm'r, supra, where the Tax Court stated that, had it found Bausch & Lomb was required to purchase its foreign subsidiary's production, the subsidiary "would have been a contract manufacturer in substance despite the fact that ostensibly the license agreement and product purchases were not interdependent" 92 T.C 525,584 (1989).

25 Gregory v. Helvering, 293 U.S. 465,469 (1935).

26 Sheppard v. United States, 361 F.2d 972 (Ct C1 1966); Grove v. Comm'r, 490 F.2d 241 (2d Or. 1973);

controlled entities nor the unexercised power to shift income among them."[27] The Committee is doubtful, even in the context of the new commensurate with income standard for intangibles, that the Service can administratively overturn prior case law in this regard. We therefore suggest that the provisions Should be eliminated.

Section 1.482-2(d)

Summary of Proposed Regulations

General

The proposed regulations provide entirely new rules to deal with transfers of intangible property. Intangibles are broadly defined to include both manufacturing and marketing intangibles.[28] A transfer of an intangible occurs if it is licensed, sold, assigned, loaned, contributed or otherwise made available in any manner.[29]

The intangible portion of the proposed regulations also applies to any transaction that in substance is a transfer of an intangible, regardless of the form of the transaction.[30] Thus, the transfer of tangible property or the provision of services is within the scope of this portion of the proposed regulations if the income attributable to the intangible is material in relation

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27 Your Host, Inc. v. Comm'r, 58 T.C 10, 24 (1972), affd, 489 F2d 957 (2d Cir. 1973), cert, denied, 419 U.S. 829 (1974).

28 See Prop. Reg. § 1.482-2(d)(1)(ii)(A).

29 Prop. Reg. § 1.482-2(d)(1)(ii)(B).

30 Prop. Reg. § 1.482-2(d)(1)(iii).

to the income attributable to the tangible property or services to which it relates (the "coordination rule").[31]

Operating Rules

Overview of Substantive Rules. The proposed regulations prescribe three methods for determining the amount of an arm's length consideration for the transfer of an intangible, i.e., the matching transaction method, the comparable adjustable transaction method and the comparable profit method.[32] In addition, the proposed regulations contain special provisions regarding transfers of intangibles for more than one taxable year[33] and for determining the owner of intangibles in cases where two or more members of a controlled group undertake the development of an intangible.[34]

Procedural Rules. The matching transaction method, comparable adjustable transaction method and comparable profit method must be applied in the order of priority listed, though the inapplicability of a higher priority method need not be specifically established before applying a method of lower priority.[35]However, a higher priority method must be used if it is established that the standards for its application are met[36]

Methods

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[31] Id. This rule is discussed in detail in the tangible property portion of the Report

[32] Prop. Reg. § 1.482-2(d)(2)(iii).

[33] Prop. Reg. § 1.482-2(d)(6).

[34] Prop. Reg. § 1.482-2(d)(8).

[35] Prop. Reg. § 1.482-2(d)(2)(iii).

[36] Id.

In applying any of the three methods, the Service may consider all relevant facts and circumstances throughout the period the intangible is used, including information from before, during and after the taxable year under review.[37] The Service is not limited to considering projections and forecasts and may consider the actual income derived from the use of an intangible.[38]

Matching Transaction Method. A matching transaction is an uncontrolled transfer of the same intangible under the same or substantially similar economic conditions and contractual terms.[39] An intangible involved in an uncontrolled transfer is the same as the intangible in the controlled transfer only if the property, protected interest or body of knowledge that is subject to exploitation through the use of each intangible is identical.[40] However, adjustments are permitted to be made for a limited number of minor differences in economic conditions and contractual terms that alone, and in combination with all of the adjustments, have a definite and precisely determinable effect on the consideration for the intangible.[41] The consideration charged in the uncontrolled transfer then must be adjusted to compensate for those differences, if any.[42]

Comparable Adjustable Transaction Method. A comparable adjustable transaction is an uncontrolled transfer of the same or a similar intangible under adjustable economic conditions and

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[37] Prop. Reg. § 1.482-2(d)(2)(iv).

[38] Id.

[39] Prop. Reg. § 1.482-2(d)(3)(i).

[40] Prop. Reg. § 1.482-2(d)(3)(ii)(A).

[41] Prop. Reg. § 1.482-2(d)(3)(v)(B).

[42] Prop. Reg. § 1.482-2(d)(3)(v)(A).

contractual terms.[43] This method can be utilized even if there are material differences in the intangibles or in the economic conditions and contractual terms, provided such differences can be determined with reasonable accuracy.[44] The consideration charged in the uncontrolled transfer then must be adjusted to compensate for those differences.[45] However, this method cannot be utilized if the operating income for the tested party from the controlled transaction determined under this method is outside of the CPI.[46]

Comparable Profit Method. This method applies the CPI to determine an arm's length consideration when the matching and comparable adjustable transaction methods are inapplicable.[47] It requires a comparison of the operating income that results from the consideration actually charged (and directly or indirectly reported on a U.S. tax return) in a controlled transfer ("reported operating income") with the CPI.[48] The consideration charged in the controlled transfer ordinarily will be considered an arm's length amount when the reported operating income falls within the CPI.[49] The consideration charged will not be considered arm's length and may be adjusted when the reported operating income falls outside the CPI.[50] Where this occurs, the transfer price generally may be adjusted to produce operating

43 Prop. Reg. § 1.48202(d)(4)(i).

44 Prop. Reg. § 1.482-2(d)(4)(ii) and (iii).

45 Prop. Reg. § 1.482-2(d)(4)(iv).

46 Prop. Reg. § 1.482-2(d)(4)(i).

47 Prop. Reg. § 1.482-2(d)(5)(i).

48 Id.

49 Prop. Reg. § 1.482-2(d)(5)(ii).

50 Prop. Reg. § 1.482-2(d)(5)(iii)(A).

income that is at the most appropriate point in the CPL[51] However, a smaller adjustment is permitted to be made when reported operating income is outside of, but corresponds closely to, the CPL[52] This special rule is limited in its application to the comparable profit method. In cases where the transferee paid no consideration in connection with the controlled transfer, or the consideration paid by the transferee was substantially disproportionate to the value of the intangible, if an adjustment is made by the Service, it must be made by reference to the most appropriate point[53]

Transfers For More Than One

Taxable Year.

If an intangible is transferred under an agreement for a term covering more than one taxable year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible.[54] The determination in an earlier year that the amount charged for an intangible is arm’s length will not preclude the Service from making an adjustment for a subsequent year,[55] except in three narrowly circumscribed situations. These three circumstances are as follows: (1) where the reported operating income of the tested party remains within the CPI; (2) where, for at least ten years since the date of the initial transfer, a royalty for the use of intangibles in commercial production has been arm’s length under one of the three methods of the regulations; and (3) where due to

51 Id.

52 Prop. Reg. § 1.482-2(d)(5)(iii)(B).

53 Prop. Reg. § 1.482-2(d)(5)(iv).

54 Prop. Reg. § 1.482-2(d)(6)(i).

55 Id.

unanticipated events the transferee's reported operating income moves outside of the CPI and the use of the intangible was limited in a commercially reasonable way.[56] To use this latter exception, it also is required that a comparable agreement between uncontrolled taxpayers contained no provision that would have permitted adjustment or termination, and no adjustment in fact was made.[57]

Developer/Assister Rules.

The proposed regulations provide rules to determine which member of a controlled group will be the "developer", i.e., the owner of an intangible, in a situation when two or more members of a controlled group undertake the intangible's development.[58] The other participating members will be regarded as "assisters."[59] Which controlled taxpayer is the developer and which other controlled taxpayers are assisters is a factual determination, with greatest weight given to which member (a) bears the direct and indirect costs and corresponding risks of developing the intangible and (b) makes available without adequate compensation property or services likely to contribute substantially to its development.[60] Other factors that may be relevant in determining which controlled taxpayer is the developer include the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer

56 Prop. Reg. § 1.482-2(d)(6)(ii).

57 Prop. Reg. § 1.482-2(d)(6)(ii)(C)(2).

58 Prop. Reg. § 1.482-2(d)(B)(i).

59 Id.

60 Id.

controls the project and the actual conduct of the controlled taxpayers.[61]

If the developer makes the intangible available to another controlled taxpayer (including any assister), the Service may make an allocation to reflect an arm's length consideration for the transfer.[62] The Service may also make allocations to reflect an arm's length consideration for assistance in the form of loans, services or the use of property provided to the developer by another controlled taxpayer.[63] Moreover, in unusual circumstances where application of the developer/assister rules would not clearly reflect the income of a member of a group of controlled taxpayers, the Service may apply the cost sharing provisions to any arrangement that in substance constitutes a cost sharing arrangement notwithstanding a failure to comply with any requirement of the cost sharing provisions.[64]

Comments

General

In replacement of the general rules of the current regulations, the Service has proposed very specific and exclusive rules (in the form of three methods) to determine an arm's length price for the transfer of an intangible. On their face, the proposed regulations continue to affirm the primacy of third-party comparables. As implemented by the proposed regulations, however, this concept is for the most part illusory because of the unlikelihood of identifying a matching transaction, or even a

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[61] Id.

[62] Prop. Reg. § 1.482-2(d)(8)(ii).

[63] Prop. Reg. S 1.482-2(d)(8)(iii).

[64] Prop. Reg. § 1.482-2(g)(2)(iii).

comparable adjustable transaction. In practice, it is likely that most determinations will have to be made under the comparable profit method, which requires using the CPI. Additionally, virtually all multi-year transfers will require validation of a tested party’s profits, generally by reference to the CPI. In view of the foregoing, the Committee believes that the proposed regulations should be modified significantly to permit the greater use of third-party comparables in determining transfer prices for intangible property in related party transactions and to de- emphasize the use of the CPI method (other than as another method or as an elective safe harbor). Our recommendations in this regard are contained below.

Definition of Intangible

The proposed regulations contain a definition of intangible substantially similar to the definition of intangible property that is incorporated in section 482 by its 1986 amendment This definition has raised concerns, however, that financial instruments, including notional principal contracts, would be included in the definition’s broad reference to “contracts,” e.g., the tax consequences of a swap negotiated abroad by a foreign affiliate of a U.S. investment bank and transferred to the U.S. entity. The Committee submits that the rules regarding the transfer of intangibles between related parties were not intended to require that the U.S. investment bank and its affiliate allocate the income generated on the swap (generally treated as fee income) in a manner consistent with the intangible portion of the proposed regulations. A statement in the final regulations that would provide a narrower limitation on the definition of intangible property would be helpful to alleviate uncertainty regarding their application.

Priority of Application of the Intangible Property Methods

The Committee endorses the procedural rules in respect of the application of the priority of methods. These rules, in concept, should allow more flexibility and, ultimately, more accuracy in determining the transfer price of intangible property. Unfortunately, in practice, the way the proposed regulations currently are structured makes it unlikely that in the vast majority of cases a method other than the comparable profit method will apply.

Matching Transaction Method

With respect to the use of the matching transaction method, the regulations include examples of matching and non-matching transactions.[65] Given that the property must be identical (e.g., updated software is not the same as an earlier version of the same software, even if the differences are not substantial) and given the broad degree of subjectivity shown to the examples as to whether differences in economic conditions or contractual terms are minor or can be adjusted definitely and precisely, there likely will be very few instances in which a matching transaction will exist or where the Service will agree with a taxpayer that a matching transaction exists. Thus, there will be few situations in which taxpayers will feel confident that they can assume that matching transactions exist and plan their transfer pricing accordingly. As such, the matching transaction method's advantage of not requiring testing by the CPI (other than in a multi-year transfer context) likely will be illusory in almost all circumstances.

[65] Prop. Reg. § 1.482-2(d)(3)(vi).

Considering the expressed concern that there not be "an artificial and unwarranted distinction between the treatment of tangible and intangible property,"[66] we recommend that the proposed regulations' requirements for the matching transaction method be relaxed so as to conform in concept with those provided for the comparable uncontrolled price method for tangible transfers. (In this regard, we are aware that the requirements of the comparable uncontrolled price method have been tightened under the proposed regulations.) The matching method should be available even if there are minor differences between the controlled and uncontrolled transfers of intangibles, as long as the effect of the differences in price are definite and reasonably ascertainable.

Comparable Adjustable Transaction Method

With respect to use of the comparable adjustable transaction method, the proposed regulations suggest a great deal of subjectivity in determining whether the intangibles, economic conditions, and contractual terms are similar, and whether the consideration can be adjusted with reasonable accuracy. For instance, reasonably determinable adjustments can be made to reflect the different levels of sophistication of two processes, different levels of manufacturing technology (with significant effects on profitability), different levels of required technical assistance, and different technical assistance costs.[67] On the other hand, where the level of technical assistance in the controlled transfer is substantially greater, is used in all aspects of manufacturing and marketing, and is a substantial factor in the controlled transferee's success, and where in the

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[66] 57 Fed. Reg. 3,574 (1992).

[67] Prop Reg. § 1.482-2(d)(4)(vi) (example 1).

uncontrolled transfer the transferee developed its own manufacturing and marketing expertise, the intangibles transferred are substantially different and adjustments for difference in economic conditions and contractual terms cannot be reasonably determined.[68] The proposed regulations provide no guidance for why the comparable adjustable transaction method applies in one instance but not the other. It is clear from the examples, however, that there likely will be many disputes between taxpayers and the Service as to whether this method applies. Thus, though use of the comparable adjustable transaction method is intended by the Service to be of somewhat broader application than the matching transaction method, identification of a comparable adjustable transaction may not be easily achievable. The Committee recommends that additional guidance be specified in the regulations as to when a comparable adjustable transaction exists. In addition, the Committee recommends that the regulations permit a taxpayer to utilize more than one comparable adjustable transaction in establishing its transfer price.

Comparable Profit Method

This method utilizes the CPI method to determine transfer prices. For the reasons discussed in the CPI section of the Report, the Committee does not believe that the comparable profit method in practice should be the primary method for determining the transfer prices of intangibles. The Committee commends the Service, however, for proposing a rule giving the Service the flexibility to limit an adjustment when a taxpayer’s income falls outside the interval by a small amount and believes that this type of a rule also should be extended to the tangible property portion of the proposed regulations.

68 Prop. Reg. § 1.482-2(d)(4)(vi) (example 3).

The Committee is concerned about how, in practice, determinations relating to reported operating income (which is a taxable income concept) will be rationalized with operating income (which is a financial income concept). See our comments in the CPI section of the Report

For reasons discussed in the International Norms section of the Report, the Committee believes that the retrospective emphasis on profits is not consistent with international norms, but recognizes that this hindsight requirement derives from the commensurate with income standard. The Committee urges the Service to limit application of the hindsight rule to the extent possible.

Addition of Another Method

The twelve factor test of the current regulations[69] also should be available to be utilized by taxpayers as a method with the modification that actual profits from the transfers of the subject intangibles be the predominant (but not the sole determining) factor in determining the transfer price. The procedural rules of the proposed regulations should be retained and the recommended twelve factor test method should be viewed as a so-called “fourth method.” The rationale for incorporating the twelve factor test is that use of a multi-factor transactional comparability analysis more accurately reflects business realities and also-is more consistent with international norms. Elevating the factor of “profitability from the transaction” to being the most important consideration is consistent with the commensurate with income standard, though not with international

[69] Treas. Reg. § 1.482-2(d)(2)(iii).

norms, as discussed below.

Procedural Rules

The procedural rules of the proposed regulations should be retained and the recommended twelve factor test method should be viewed as another method that ranks below the matching transaction and comparable adjustable transaction methods.

Multi-Year Transfers

The proposed regulations require multi-year transfers to be revalidated annually unless the conditions for the application of the three exceptions discussed above apply. This requirement is meant to emphasize the retrospective nature of transfer pricing and the use of actual (rather than projected) results. As such, this requirement reflects the Congressional reversal of the rule existing prior to the 1986 amendment that transfer pricing should be based on the conditions existing at the time the intangible transfer was entered into.[570] The Committee is cognizant of the legislative history to the commensurate with income standard that requires an ongoing review of profits.[71] Nonetheless, a major problem exists with this type of an approach because it appears to be contrary to international norms, as discussed below. Moreover, the three exceptions contained in the proposed regulations that except certain transactions from a retrospective analysis are too restrictive.

The first exception is meant to preclude the Service from requiring the taxpayer to utilize the results obtained under

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[70] See R.T. French Co. v. Comm'r, 60 T.C. 836 (1973) and Bausch & Lomb, Inv. v. Comm'r, supra.

[71] Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986,1016 (Comm. Print 1987)

the matching transactions method or the comparable adjustable transaction method where the reported operating income of the tested party is within the CPI for all years subsequent to the year of transfer, including the taxable year under examination. Though the concept of not requiring the application of a higher primary method in this case is helpful, this exception is of limited use because of the fact that the CPI must be performed in all events. The same is true of the second exception where (1) the transfer must be within the CPI for the 10 consecutive years prior to the year under examination and must be determined to be arms length under the matching transaction method or comparable adjustable transaction method, or (2) the transferee's reported operating income must be within the CPI for the prior 10 years and the year under examination. The third exception is meant to deal with situations beyond the taxpayer's control. However, it is so narrowly drawn that it too may not prove to be particularly useful. The Committee recommends that the Service consider modifying the exceptions to multi-year re-examinations to expand their scope.

Developer/Assister Rules

The developer/assister rules are intended to establish which member of a controlled group will be regarded as the owner of an intangible for section 482 purposes. The principal factors in making this determination are which member of the controlled group bears the costs of development and which member makes available property or services without adequate compensation.

In concept, the proposed regulations seek to clarify these important rules. However, the Committee is concerned that the Service may have posited a substantive rule in Example 4 of section 1.482-2(d)(8)(iv) of the proposed regulations which is not in accord with the principles of the developer/assister rules and, if adopted, would have the potential of inappropriately applying them. That example involves a U.S. subsidiary that distributes products of its foreign parent and bears the expenditures (for which it is not reimbursed by its foreign parent) of developing the foreign parent's trade name in the United States. The trade name is widely known and is valuable outside the United States but is not known within the United States. The example holds that since the U.S. subsidiary bears the expenditures to develop the U.S. trade name and is not reimbursed for its expenditures by its foreign parent, it is the developer of the trade name and thus entitled to the return thereon.

As an initial matter, the example does not recognize that it is commonplace that when a manufacturer sells products to a distributor, it generally sells the products at a price which permits the distributor to incur certain expenditures, including advertising. Thus, if this practice were to have occurred in the example, the expenditures incurred by the U.S. subsidiary should not be viewed as unreimbursed.

Second, the way the example is constructed, it could attribute income to the subsidiary incurring the expenditures in cases where such an attribution would not be appropriate. A trade name derives value both as a marketing intangible and as a manufacturing intangible. As applied to the facts of the example, the trade name is a marketing intangible as a result of the U.S. subsidiary's efforts to enhance the trade name's recognition in the United States through advertising. A trade name is a manufacturing intangible as a result of its association with products of a particular quality which are produced by the manufacturer (and developer of the trade name outside of the

United States). Thus, in the example, the Committee believes that it is not appropriate to allocate all of the income attributable to the enhanced U.S. rights to the trade name to the U.S. subsidiary since a portion of the value of the trade name is properly attributable to the foreign parent, and the Committee recommends that the Service reconsider the example in view of the foregoing comments. (Query whether the Service would apply this same approach in an "outbound" context?)

Section 1.482-2(e)

Summary of Proposed Regulations

General

The proposed regulations retain portions of the current regulations relating to transfers of tangible property, engraft new substantive requirements to these rules and modify the priority of application of the rules of the current regulations.

Operating Rules

Substantive Rules. The proposed regulations retain the comparable uncontrolled price method of the current regulations and continue to require that it be used prior to any other method.[72] Under the current regulations, the comparable uncontrolled price method can be used only if any differences in the tangible property and circumstances of the uncontrolled sale have a definite and reasonably ascertainable effect on the price.[73] The proposed regulations clarify the differences which may affect the price in uncontrolled sales by adding sales

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[72] Prop. Reg. § 1.482-2(e)(1)(ii).

[73] Reg. § 1.482-2(e)(2)(ii).

volume, inventory turnover rate, and advertising and warranty practices to the differences listed in the current regulations; Le., quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place.[74]

If the comparable uncontrolled price method cannot be used, second priority is given either to the resale price method or the cost plus method, depending on which of these two methods more accurately results in an arm’s length price in the particular factual situation.[75] Under both methods, however, the transfer price determined must result in a level of operating income for the tested party that is within the CPI.[76]

Finally, third priority is given to the so-called “fourth methods.”[77] A fourth method, for example, may include an analysis based on profit level indicators used to construct a CPI.[78] In order to utilize a fourth method, however, the transfer price determined under such method generally must result in a level of operating income for the tested party that is at the most appropriate point within the CPI.[79]

Procedural Rules. For purposes of applying the priority of methods, the proposed regulations do not require the Service or the taxpayer to demonstrate the inapplicability of a higher

[74] Prop. Reg. § 1.482-2(d)(2)(ii).

[75] Prop. Reg. § 1.482-2(e)(1)(ii).

[76] Prop. Reg. § 1.482-2(e)(1)(iii).

[77] Prop. Reg. § 1.482-2(e)(1)(iv).

[78] Id.

[79] Id. This expression of the rule reflects our understanding of the intent of the drafters of the proposed regulations, though the wording of the proposed regulations meant to effectuate this intent is not expressed as clearly as it might have been.

priority method before applying a lower priority method.[80] However, either the Service or the taxpayer may establish the applicability of a higher priority method.[81]

Coordination Ride. Additionally, and very significantly, the intangible property rules may apply to the transfer of tangible property. As mentioned above, the intangible property portion of the proposed regulations applies to any transaction in which the transfer of an intangible occurs through transfers of tangible property, if the income attributable to the intangible is material in relation to the income attributable to the tangible property to which it relates.[82]

Grouping. Finally, the proposed regulations continue to apply the grouping rules of the current regulations. Under these rules, even though the methods for determining arm’s length prices for tangible goods refer to individual sales of property, because a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for die purpose of determining the arm’s length price.[83] Thus, an arm’s length price may be determined or verified by applying the pricing method to product lines or other groupings where it is impractical to ascertain an arm’s length price for each product or sale.[84] In addition, the Service may determine or verify the arm’s length price of all

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[80] Prop. Reg. § 1.482-2(e)(1)(ii).

[81] Id.

[82] Prop. Reg. § 1.482-2(d)(1)(iii).

[83] Prop. Reg. § 1.482-2(e)(1)(v).

[84] Id.

sales to a controlled taxpayer by employing reasonable statistical sampling techniques.[85]

Comments

General

On their face, the proposed regulations’ affirm the primacy of the comparable uncontrolled price method. Similar to the rules for intangibles, only the comparable uncontrolled price method for determining transfer pricing need not be verified by the CPL While the comparable uncontrolled price method does not require the exactitude of the matching transaction method, the proposed regulations’ “clarification” of when a comparable exists most likely will make it more difficult to establish a comparable in practice.[86] Thus, in practice, the proposed regulations most likely will require that the charge for transfers of tangibles, as with transfers of intangibles, be measured using the CPI.

A number of problems arise by reason of the requirement that methods other than the comparable uncontrolled price method be validated by reference to the CPI. As an initial matter, this rule causes major portions of the rules crafted for intangibles, and their concomitant problems as described above, as well as others, described below, to apply to the transfer pricing of tangible property. This significantly alters the prior rules of the game and will vitiate the use of resale price and cost plus methods. Additionally, while the proposed regulations provide additional guidance with respect to fourth methods, to require

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85 Id.

86 This addition presumably was in response to the criticism contained in the legislative history to the commensurate with income standard in respect of the use of comparables, particularly as applied in the U.S. Steel case. See U.S. Steel Corp. v. Comm’r, 617 F.2d 942 (2d Cir. 1980), rev g 36 TCM (C.C.H.) 586 (1977).

use of a fourth method that results in a level of operating income for the tested party at the most appropriate point within the CPI is not very helpful. The Committee believes that the proposed regulations should be modified significantly to limit the applications of the CPI method. Our recommendations in this regard are contained below.

Priority of Application of the Tangible Property Methods

The Committee endorses the modifications that the proposed regulations make to: the procedural rules that apply priorities to the methods for transfers of tangible property. Under the current regulations, the comparable uncontrolled price method must be used if applicable. If the comparable uncontrolled price method is not applicable, the resale price method must be used if applicable, and only if this method is not applicable may the cost plus method be used.[87] The proposed regulations retain the requirement that the comparable uncontrolled price method must be applied if applicable, but provide that if the comparable uncontrolled price method is not applicable "the amount of an arm's length consideration must be determined under either the resale price method or the cost plus method, depending on which method relies on the most complete and accurate data, and requires the fewest and most readily quantifiable adjustments."[88]

This modification allows more flexibility and, ultimately, more accuracy in determining the transfer price of tangible property. Although the new standard could create additional uncertainty in setting transfer prices in certain

87 Reg. § 1.482-2(e)(1)(ii).

88 Prop. Reg. S 1.482-2(e)(1)(ii).

situations, the Committee believes that this standard is fairer than the current standard, at least if applied judiciously by the Service.

Authority for the Application of the CPI to Tangible Property

The proposed regulations apply the CPI to transfers of tangible property. In the view of the Committee, the statutory basis for the application of the CPI to transfers of intangible property is not clear, as is discussed in more detail below and in the CPI portion of the Report The Service's extension of this methodology to tangible property transfers rests on considerably shakier statutory ground.

There are two possible sources of statutory authority for the application of the CPI test to intangible property transfers. First, one might argue that because the Secretary is empowered under section 482 to make adjustments to clearly “reflect the income” of a controlled taxpayer, the Secretary can require, as a means of testing what a taxpayer’s “true” income is, that the taxpayer’s reported income be similar to the incomes of the comparable taxpayers. The problem with this approach is that the Service’s own longstanding interpretation of section 482 has never required anything remotely resembling the CPL Surely, such a radical departure from the Service’s prior methods of determining transfer prices should only be in response to a specific Congressional directive.

A second possible source of statutory authority is the commensurate with income amendment to section 482. The CPI might be justified as a means of determining whether the price paid for an intangible is commensurate with the income generated by the intangible. This appears to be the approach adopted by the Preamble to the proposed regulations. The, Preamble claims that the proposed regulations "provide guidance implementing the [1986] amendment"

Under this approach, however, there is very little justification for the Service's extension of the CPI to tangible property. The Preamble purports to derive authority to apply the CPI to tangible property from language in the Conference Report accompanying the 1986 amendment which states that the conferees believe "careful consideration should be given to whether the existing regulations could be modified in any respect"[89] Considering, however, that the Service has long applied section 482 to tangibles without resort to such methodology, such a radical shift in policy should require more than such vague language in a conference report

The Preamble claims that applying the CPI to tangible property "is necessary because applying the comparable profit interval solely to transfers of intangibles would create an artificial and unwarranted distinction between the treatment of tangible and intangible property, and would lead to disputes in cases involving tangible property incorporating an intangible." This problem could be easily remedied with a properly drafted coordination rule, as suggested below in this Report This concern certainly does not justify the wholesale application of the CPI to all transfers of tangibles where exact comparables cannot be found As the Supreme Court once said, "[a]gainst the Treasury's prior longstanding and consistent interpretation, its more recent

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[89] H.R. Conf. Rep. No. 841, 9 9th Cong. 2d Sess. II-638 (1986).

ad hoc contention as to how the statute should be construed cannot stand."[90]

To appreciate how radical the proposed regulations are, especially in regard to tangible property, it is necessary to briefly trace the development of the Service's interpretation and application of section 482. The early cases dealing with section 482 and its predecessor, section 45 of the 1939 Code, applied a wide variety of methods to establish the proper "distribution, apportionment, or allocation" of income between related parties, and rejected the Commissioner's efforts to apply the arm's length standard to such transactions.[91] However, the regulations promulgated under section 482, adopted in 1962, stated clearly that "[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer".[92]

The arm's length standard embodied in the regulations was subsequently upheld in a series of court cases in which taxpayers attempted to attack the Commissioner's authority to use it as the sole standard in applying section 482.[93] In 1972, the Fifth Circuit went so far as to hold that no quantum of evidence as to taxpayer's internal transactions with its subsidiaries can be sufficient to meet the arm's length standard.[94]

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90 United States v. Leslie Salt Co., 350 U.S. 383,396 (1956).

91 See, e.g., Frank v. International Canadian Corporation, 308 F.2d 520 (9th Or. 1962), and the cases cited therein.

92 Reg. § 1.482-1(b)(1).

93 See, e.g., oil Base Inc. v. Comm'r, 23 T.C.M. (CCH) 1838 (1964), affd, 362 F2d 212 (9th Cir. 1966); Eli Lilly & Co. v. Comm'r, 372 F.2d 990 (Ct. CL. 1967); Woodward Governor Co. v. Comm'r, 55 T.C. 56 (1970).

94 Lufkin Foundry and Machine Co. v. Comm'r, 468 F.2d 805 (5th Cir. 1972).

In 1962, Congress responded to perceived tax avoidance by multinational enterprises by considering legislation to expand section 482 by adding a new subsection dealing with sales of tangibles, which, if comparable transactions could not be found, would have apportioned the income between the related parties under a formula based on their relative economic activities.[95] However, the proposal was rejected in conference and instead the Service was given regulatory authority to deal with the issue.[96] In response, the Service adopted in 1968 the present regulations dealing, inter alia, with sales of tangible property, which implemented the arm’s length standard by establishing the comparable uncontrolled price, resale price and cost plus methods, which focus upon either comparable transactions between unrelated entities or the prices and costs of the taxpayer in dealing with unrelated entities.[97]

Since the enactment of the present regulations, however, most of the cases that focused on transfer prices of tangibles have failed to apply any of the three methods of the regulations because of the absence of comparable transactions and the inapplicability of the resale price or cost plus methods.[98] (In fact, in the few cases where the courts have used comparables, the Service has been generally displeased with the result and is

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95 H.R. 10650, 87th Cong., 2d Sess. § 6 (1962).

96 H.R. Rep. No. 2508, 87th Cong., 2d Sess. 18-19 (1962).

97 Reg. § 1.482-2(e).

98 See, e.g., PPG Industries, Inc. v. Comm’r, 55 T.C. 928 (1970); Dallas Ceramic Co. v. United States, 598 F2d 1382 (5th Cir. 1979); Edwards v. Comm’r, 67 T.C. 224 (1976); E.I. DuPont de Nemours v. United States, 608 F.2d 445 (CL CL 1979), cert denied 445 U.S. 962 (1980); Eli Lilly and Co. v. Comm’r, 84 T.C. 996 (1985); Sundstrand Corp. v. Comm’r, supra.

seeking to overturn them in the proposed regulations.)[99] Instead, the courts have increasingly resorted to the so-called "fourth method" of the present tangible regulations, under which the taxpayer can use "some appropriate method of pricing other than" the regular methods when, under its facts and circumstances, none of the other methods apply.[100] Increasingly, the method used by the courts involved an analysis of the respective economic functions performed by the parties to the transaction and an allocation of the income based on those functions.[101]

In 1986 Congress enacted the "commensurate with income" standard for intangibles. In addition, the Conference Report stated that -

> The conferees are also aware that many important and difficult issues under section 482 are left unresolved by this legislation. The conferees believe that a comprehensive study of intercompany pricing rules by the Internal Revenue Service should be conducted and that careful consideration should be given to whether the existing regulations could be modified in any respect[102]

The first part of this mandate was discharged in 1988 by the publication of the White Paper.[103] After surveying the applicable court cases, the White Paper developed the "basic

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99 U.S. Steel v. Comm'r, supra', Bausch & Lomb, Inc. v. Comm'r, supra.; cf. Paccar, Inc. v. Comm'r, 85 T.C. 754 (1985); Prop. Reg. § 1.482-2(e)(2)(ii) and Example 5.

100 Reg. § 1.482-2(e)(1)(iii).

101 See, e.g., E.I. Du Pont de Nemours v. United States, supra, Eli Lilly v. Comm'r, supra, Bausch & Lomb v. Comm'r, supra, and Sundstrand v. Comm'r, supra; and compare for intangibles Ciba Geigy Corp. v. Comm'r, 85 T.C. 172 (1985); G.D. Searle & Company, Inc. v. Comm'r, supra; Bausch & Lomb, v. Comm'r, supra, Merck & Company, Inc. v. United States, supra; and for services Hospital Corporation of America v. Comm'r, 81 T.C. 520 (1983).

102 H.R. Conf. Rep. No. 841,99 Cong. 2d Sess. II-638 (1986).

103 Notice 88-123, A Study of Intercompany Pricing under Section 482 of the Code, 1988-2 C.B. 458 (hereinafter, the "White Paper").

arm’s length return method” (“BALRM”) for intangibles. In the absence of comparables, BALRM analyzed the economic functions performed by the parties to the transaction and the income attributable to such functions on the basis of rates of return to assets or other factors of unrelated entities performing similar economic activities and undertaking similar economic risks.[104] The White Paper did not apply BALRM explicitly to tangibles, but recommended that the rules for tangibles and intangibles should not differ too much.[105]

The proposed regulations, which should discharge the second part of the Conference Report’s 1986 mandate, represent a sharp deviation both from the court cases applying a functional analysis and from the White Paper. The proposed regulations apply the CPI as a check on all methods of establishing transfer prices of tangibles in the absence of comparables. For example, unlike BALRM, the CPI method looks exclusively at the profits of other taxpayers to determine the proper allocation within the controlled group.[106] In fact, the CPI method, as applied to tangibles, is in reality a formula - a standardized way of arriving at a “correct” transfer price that disregards the internal data of the taxpayer completely. Not even the Lufkin court went so far as to say that the taxpayer’s internal data are irrelevant in making transfer pricing determination.[107]

Furthermore, as noted above and as discussed in more detail below, in the Committee’s view the CPI method also runs counter to the legislative history of the 1986 amendments, which

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[104] White Paper, at 488-493.

[105] White Paper, at 492.

[106] See Prop. Reg. § 1.482-2(e),(f).

[107] See supra note 90 and accompanying text

the Preamble of the proposed regulations relies on as authority for modifying the tangibles rules. The House Committee Report on the amendment states that “industry norms or other unrelated party transactions” should not constitute the basis for section 482 adjustments for intangibles, let alone tangibles.[108]

In effect, the Service has proposed eliminating all fourth methods other than one computed under the CPI and putting an end to judicial attempts to experiment with other possible methods for judging transfer prices.[109] Furthermore, it has proposed this change without any analysis in either the White Paper or the proposed regulations supporting a conclusion that the CPI should be the only fourth method. If it were clear that the CPI method were superior to any alternative method, the Service might be justified in attempting to cut off the development of other such methods. That, however, is not the case. As the Report indicates, there are many reasons to believe that the CPI method is far from the ideal method for determining the transfer prices of tangibles.

The Committee considers that the Service has overstepped its authority in proposing that the CPI method apply to transfers

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108 H.R. No. 426, 99th Cong., 1st Sess. 425 (1985); Cf. Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 1015 (Comm. Print 1987) (the “Blue Book”): “Congress intended to make it dear that industry norms or other unrelated party transfers do not provide a safe-harbor for related party intangible transfers”.

109 Judicial attempts to fashion appropriate transfer prices have used a number of different methods, including profit splits (Hospital Corporation of America v. Comm’r, supra.; Eli Lilly & Co. v. Comm’r, supra; PPG Industries Inc. v. Comm’r, supra).; rates of Judicial attempts to fashion appropriate transfer prices have used a number of different methods, including profit splits (Hospital Corporation of America v. Comm’r, supra.; Eli Lilly & Co. v. Comm’r, supra; PPG Industries Inc. v. Comm’r, supra).; rates of return and income to expense ratios (E.I. DuPont de Nemours & Co. v. United States, supra); and customs valuations (Ross Glove Co. v. Comm'r, 60 T.C. 569 (1973). See the White Paper, at 36-44, for a discussion of such fourth methods.

of tangible property. Therefore, as expressed in the Committee’s recommendations below, at the very least the Service should leave open the possibility of using appropriate methods that are independent of the CPI method.

Comparison of the Tangible Property and Intangible Property Rules

As mentioned above, the Preamble to the proposed regulations states that application of the CPI to tangibles in some cases is necessary because applying it solely to intangibles “would create an artificial and unwarranted distinction between the treatment of tangible and intangible property, and would lead to disputes in cases involving tangible property incorporating an intangible,” especially in regard to the proper allocation of value between the tangible and intangible components of the transfer. Nevertheless, the proposed regulations do not treat tangibles and intangibles consistently; sometimes the tangible rules are more stringent than the intangible rules and sometimes they are less stringent For the reasons described above, the Committee strongly objects to the application of CPI method to tangible property. In the event, however, that CPI concepts are to be applied to tangible property despite these objections, arbitrary inconsistencies between the rules for tangible and intangible property should be eliminated.

In regard to the circumstances in which the CPI test need not be applied, the intangible rules appear to be somewhat stricter than the tangible rules. For intangibles, the only transfers that do not require the CPI test are those strictly defined “matching transactions” (which must involve the “same intangible under the same or substantially similar economic conditions and contractual terms”).[110] If the matching transaction method is not applicable, the next method in order of priority is the comparable adjustable transaction method.[111] Under the comparable adjustable transaction method, the arm’s length consideration is determined by reference to the consideration charged in an uncontrolled transfer involving the same or similar intangible under “adjustable” economic conditions and contractual terms.[112] To be considered adjustable, the contractual terms and economic conditions must be sufficiently similar that the effect of any material differences can be determined with reasonable accuracy.[113] However, even if all the other conditions for applying the comparable adjustable transaction method are met, “[a]n uncontrolled transfer will not meet the standards [of the comparable adjustable transaction method] if the consideration determined by reference to that transfer results in a level of operating income for the tested party... that is outside of the comparable profit interval.”[114]

On the other hand, in the case of transfers of tangible property, the method that does not require a CPI test is the comparable uncontrolled price method.[115] Under the comparable uncontrolled price method, “the arm’s length price of a controlled sale is equal to the price paid in comparable uncontrolled sales,” subject to certain adjustments. Controlled and uncontrolled sales are considered comparable “if the physical property and circumstances involved in the uncontrolled sales are

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110 Prop. Reg. § 1.482-2(d)(3).

111 Prop. Reg. § 1.482-2(d)(2)(iii).

112 Prop. Reg. § 1.482-2(d)(4)(i).

113 Prop. Reg. § 1.482-2(d)(4)(iii).

114 Prop. Reg. § 1.482-2(d)(4)(i).

115 Prop. Reg. § 1.482-2(e)(1)(ii).

identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales."[116]

One of the examples that the proposed regulations provide of a situation in which the comparable uncontrolled price method may be used is where the circumstances surrounding the controlled and uncontrolled sales of business machines are identical, except that, in the controlled sales, the manufacturer "makes certain minor modifications in the physical properties of the machines to satisfy safety specifications or other specific requirements of a customer." The example states that since such "minor physical differences in the product generally have a definite and reasonably ascertainable effect on prices," the comparable uncontrolled price method may be applied.[117]

Thus, in the case of intangibles, a determination of the CPI can be avoided only in those rare cases where a precise matching transaction can be found. If the intangibles are not the "same," the matching transaction method cannot be used. In the case of tangibles, it is necessary only to find an inexact comparable that can be adjusted to determine the transfer price to avoid resort to the CPL Such inexact comparables have frequently been used in cases involving tangible assets.[118] The White Paper found that the comparable uncontrolled price method was used in 32 percent of the cases it surveyed.[119]

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116 Reg. § 1.482-2(e)(2).

117 Reg. § 1.482-2(e)(2)(ii).

118 See, e.g., Bausch & Lomb v. Comm'r, supra.

119 White Paper, at 463,502.

As stated above, the Committee recommends that the proposed regulations' requirements for the matching transaction method be modified so as to conform in concept with those provided for the comparable uncontrolled price method. The matching transaction method should be available even if there are minor differences between the controlled and uncontrolled transfers of intangibles, as long as the effect of the differences in price is definite and reasonably ascertainable.

In regard to when the most appropriate point of the CPI must be used, however, the tangible rules are considerably more stringent than the intangible rules. If the comparable uncontrolled price method, the resale price method, and the cost plus method cannot reasonably be applied to determine a transfer price, any "fourth method" may be used, but only if "that method yields a level of operating income for the tested party that is within the comparable profit interval…."[120] The proposed regulation provides further that such a method may include any of the profit level indicators used to construct the comparable profit interval,[121] but "[g]enerally, the best such method will result in operating income for the tested party that is at the most appropriate point within the CPI interval…."[122]

Because the proposed regulations require any fourth method to mimic the results of the comparable profit method, they effectively mandate that method for all cases in which a higher priority method is not reasonably applicable. At first glance, this places the transfer of tangibles on an equal footing with intangibles, for which the comparable profit method is mandated

[120] Prop. Reg. § 1.482-2(e)(4).

[121] Prop. Reg. § 1.482-2(f)(6)(iii).

[122] Prop. Reg. § 1.482-2(e)(1)(iv).

as the last priority method.[123] In fact, however, the fourth method of setting the transfer price of tangible goods is even less flexible than the comparable profit method used for the transfer of intangibles. For intangible transfers, the tested party's operating income need only fall within the comparable profit interval,[124] and if operating income does not deviate significantly from that interval, the transfer price is adjusted only enough to bring operating income within that interval.[125] The transfer price of an intangible would be adjusted to bring operating income to the "most appropriate point" within the interval only if operating income falls significantly outside that interval.[126] In the case of tangibles, however, the transfer price generally must generate operating income that is at the most appropriate point within the comparable profit interval Thus, the fourth method is effectively limited to the strictest application of the comparable profit method.

Even if the Service believes that there are no methods other than the comparable uncontrolled price method that do not need to be conformed with the CPI, it should not make the application of that confirmation any stricter than the application of the comparable profit method in the case of intangibles. Operating income should therefore be required only to fall within the CPI, and insignificant deviations from the CPI should lead to only enough of a price adjustment as is necessary to bring operating income within that interval.

CPI and Hindsight

[123] Prop. Reg. § 1.482-2(d)(5).

[124] Prop. Reg. § 1.482-2(d)(5)(ii).

[125] Prop. Reg. § 1.482-2(d)(5)(ii)(B).

[126] Prop. Reg. § 1.482-2(d)(5)(ii).(A)

The CPI is constructed using data for uncontrolled taxpayers from the tested tax year, the preceding tax year, and the following tax year.[127] That data could easily include profit level indicators for companies that dealt in comparable goods after the time that unexpected changes in market conditions had caused fluctuations in market prices and, consequently, in profit levels. Therefore, related taxpayers that establish arm’s length transfer prices based on the resale price method, the cost plus method, or some “fourth” method, will have their transfer prices recomputed based on events that occur after their transfer is complete. They face the risk of having their income recomputed to reflect, in part, conditions that did not exist at the time of their transaction and did not affect the terms of their transaction.

This quandary exemplifies how the CPI, which was designed with transfers of intangibles in mind, may operate poorly in the case of transfers of tangible property held for resale by the transferee. An intangible asset is often valuable because it generates a stream of income over the course of its useful life. That stream of income will vary over time as conditions vary, and it is difficult to predict its course given the limited facts known at the time the intangible is transferred.[128] Therefore, it is not beyond reason to allow for the possibility in some cases of judging the adequacy of the royalty by reference to the actual course of the intangible’s usefulness, as measured by the income it generates.

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[127] Prop. Reg. § 1.482-2(f)(2). The proposed regulations specify that the CPI is constructed using data for the three-year period centered on the tested year, but it is not clear whether the appropriate year to test profits derived from the transfer of tangible goods is the year of the transfer or the year the goods are resold.

[128] Cf. The White Paper at 46-47.

The sale of a tangible good, however, generally is not an ongoing transaction. Such a transaction is generally complete from the moment the transfer occurs, and parties that deal at arm's length contract for the purchase and sale of goods based solely on market conditions that exist at the time of the sale. In general, neither party generally expects that the seller will reap any rewards from future increases in the market price of the goods or absorb any detriment that the purchaser experiences from an unexpected decrease in that price.

The application of the CPI to the transfer of tangible goods held for resale is not a realistic measure of arm's length transfer prices in this context because it forces related taxpayers to reset transfer prices based on post-transfer conditions that would not affect transfers between unrelated parties and that could not have been taken into account in their own transactions. If some measure of profitability is to be used to confirm transfer prices for tangible goods, it should at minimum be based only on operating incomes generated by sales of tangibles under the same market conditions as the tested transfers. This, however, may not be feasible because market conditions for tangibles may change so rapidly and unexpectedly that it is impossible to establish an appropriate fixed length time interval in which to take data for constructing the appropriate comparable profit interval.

CPI and Effectively Connected Income

The retrospective quality of using future profitability to construct a CPI for transfers of tangible goods may also affect other provisions of the Code and taxpayers' ability to predict how their business arrangements will be treated under such provisions. A foreign corporation could face this problem when it attempts to determine whether the sale of tangible goods to a U.S. affiliated distributor will cause it to be engaged in a U.S. trade or business or have U.S. effectively connected income. Typically, a foreign corporation will take comfort that such « sale will not cause it to be engaged in a U.S. trade or business or to generate effectively connected income because the economic benefits and burdens of ownership of the goods are surrendered to the U.S. affiliate upon the transfer of the goods to that affiliate. After such transfer is complete, the U.S. affiliate resells the goods for its own account and not as an agent for its foreign parent

The use of the CPI to confirm an otherwise arms length transfer price, however, raises some questions as to the effectiveness of such an arrangement. One could argue that the CPI in effect forces the foreign corporation to retain a share of at least the economic burdens of ownership of the goods after they are “sold” to the U.S. affiliate. For example, if market prices for the goods were to plummet after transfer to the U.S. affiliate, or if the U.S. affiliate’s customers were to default on payments for the goods, the CPI method would require the foreign corporation to adjust its transfer price so as to restore the U.S. affiliate to profitability. In essence, the foreign corporation would be the party bearing the economic risk with respect to the goods under these circumstances. It might, therefore, follow that what is in form a buy/sell relationship is in substance a principal/agent relationship and that the foreign corporation therefore is engaged in a U.S. trade or business or, even worse, has effectively connected income.[129] If the CPI is retained in the final regulations, it would be helpful to clarify that the construction of the CPI will not have the corollary effect of causing a foreign corporation not otherwise engaged in a U.S. trade or business to become so engaged or to generate effectively connected income where none would otherwise have been generated.

Coordination of the Tangible and Intangible Rules

The coordination rule provides that the intangible property rules apply "to any transaction in which the transfer of an intangible occurs through transfers of tangible property or services, if the income attributable to the intangible is material in relation to the income attributable to the tangible property or services to which it relates."[130] The regulation does not provide guidelines as to when a "transfer of an intangible occurs through transfers of tangible property or services." One might therefore read this provision to apply only to situations in which a transfer of services or of tangible property is really a disguised transfer of an intangible, such as the transfers of managerial services that were found to be intangibles in Hospital Corporation of America v. Comm'r.[131]

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129 See Rev. Rul. 70424, 1970-2 CB. 150, on the issue of engaging in a U.S. trade or business though a U.S. agent Effectively connected income could be generated if the U.S. affiliate were viewed as a dependent agent filling orders not on its own behalf but on behalf of the foreign corporation out of a stock of goods belonging to the foreign corporation. The permanent establishment and business profits articles of tax treaties may furnish additional protection to treaty-protected foreign corporations from the argument that the dependent agent's activities cause it to generate effectively connected income.

130 Prop. Reg. § 1.482-2(d)(1)(iii).

131 81 T.C. 520,598-601 (1983). See discussion of "disguised" intangibles of text in this section of the Report

However, Example 3 of section 1.482-2(f)(11) of the proposed regulations demonstrates that the coordinating rule is intended to be given a much broader reading. In the example, Foreign Parent (FP) manufactures a consumer product and has developed a trademark "that has significant U.S. marketing value." FPs U.S. subsidiary imports the product and sells it in the United States using FFs trademark without a separate license. The example applies the intangible property rules of the proposed regulations, rather than the tangible property rules of the proposed regulations.

On its face, the coordinating rule and the example thereunder would appear to require a bifurcation of the income attributable to the single transfer of tangible and intangible property.[132] If the income attributable to the intangible is material, however, the income streams are put back together and the intangible property rules apply, rather than the tangible property rules. This rule is one of potentially major significance because virtually all types of tangible property are likely to involve some intangible. As such, it appears that the only tangibles which would be subject to the tangible transfer provisions of the regulations are commodities.

Most products other than commodities bear a trademark, trade name, or brand name and many if not most of these intangibles could be said to generate income that is material in relation to the income attributable to the tangible property that it identifies.

Even in situations in which the income generated by the marketing intangibles is not considered "material," the

[132] Such bifurcation is contrary to the Service's position in Rev. Rul 75-254, 1975-1 C.B. 243.

coordinating rule, as proposed, could require the application of the intangible rules. The proposed regulations provide a very broad definition of intangibles for purposes of section 482.[133] This definition includes patents, know-how, copyrights, trademarks, trade names, brand names, and various types of technical and marketing data. Thus, the coordinating rule might apply when a tangible is transferred that was manufactured using an intangible. Some commentators have suggested that the rule might even be applied where a manufacturing intangible is used to produce a product that could have been produced without use of the intangible. Carried to that extreme, the potential theoretical effect of the rule is that the comparable uncontrolled price, resale price, cost plus, or “fourth” methods of determining tangible property sales in the regulations would not apply at all to tangible property sales (other than sales of commodities).[134]

The Committee recommends that the coordinating rule be modified so as to apply only in certain limited circumstances. The rule, as currently proposed, would lead to unacceptable

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[133] Prop. Reg. § 1.482-2(d)(1)(ii)(A). For purposes of defining which intangibles are subject to the commensurate with income” standard, this definition of intangibles is required by section 482, which refers to the definition of intangible property contained in section 936(h)(3)(B).

[134] The practical effect of this rule, however, may be somewhat less significant (except in a transaction in which the comparable uncontrolled price method would otherwise apply), since the other tangible property pricing rules require validation by the CPI and the intangible property rules are less harsh (as discussed above) than the tangible property rules.

uncertainty and counterproductive results.[135] In addition, the proposed rule is inconsistent with international norms.[136]

The situation in which it would make the least amount of sense to apply the intangible rules is where the comparable uncontrolled price method would otherwise apply if the tangible rules were applied. The proposed regulations apply the CPI test to all methods of valuing tangibles except for the comparable uncontrolled price method, presumably because the comparable uncontrolled price method is sufficiently accurate that the CPI test is not needed. If comparable tangible products are being sold in uncontrolled transactions at a certain price, this should be the arm's length price, regardless of what the CPI is. To apply the intangible rules would result in unjustifiable inaccuracy and, in some cases, the complete abrogation of the arm's length standard.

For example, if FP, a foreign toothpick manufacturer, developed a toothpick manufacturing process that allowed it to produce toothpicks at a quarter of the cost of other toothpick manufacturers, and FP sold those toothpicks to FFs U.S. subsidiary, USS, the CUP method would most probably be applicable to compute the transfer price under the tangible portion of the proposed regulations. Uncontrolled sales of identical or nearly identical toothpicks should provide the arm's length transfer price for the controlled sales.

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135 Service officials have recognized that the coordinating rule needs clarification. See BNA Daily Tax Report, March 17, 1992, at G-8 (comments of Associate Chief Counsel (International) Robert Culbertson); id., March 31, 1992, at G-8 (comments of Attorney- Advisor Howard Berger).

136 The Committee is unaware of any other country that has adopted such a rule. See discussion infra pp. 95-113.

If the intangible rules were used, it is possible that only the comparable profit method would be appropriate. If no other toothpick manufacturer used FP's manufacturing process, the matching transaction method would not be applicable. Considering that FPs process is so significantly less expensive than the other processes available, "similar" intangibles might be hard to find, so the comparable adjustable transaction method would not apply. Therefore, the comparable profit method would be used and generally USS would be the "tested party."[137] As long as USS's reported operating income was within the CPI, the transfer price would be upheld, even if the price that uncontrolled manufacturers charged for their toothpicks was very different Considering the subjectivity and inaccuracy that is involved in creating a CPI, there is no justification for abandoning the relatively accurate comparable uncontrolled price method for the comparable profit method.

If, for some reason, FP was found to be the appropriate "tested party,"[138] the result would be even more egregious. Because FFs manufacturing costs are so much lower than its competitors' due to its manufacturing intangible, other toothpick manufacturers might not be considered to have operations similar to FP and, therefore, the constructive operating income of these

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137 The transferee of the intangible property would generally be the "tested party" in such a situation. Prop. Reg. § 1.482-2(f)(4)(ii).

138 This could happen, for example, if USS did not sell the toothpicks but rather used them in USS's catering business. In this situation, it would be unreasonable to choose USS to be the tested party and to adjust the price of the toothpicks to give USS a reporting operating income that falls within the CPI of comparable catering businesses. Therefore, FP would have to be the tested party. A more common example of where FP might be considered the more appropriate tested party is where USS is also a manufacturer and FFs product is a small component in a product that USS manufacturers.

manufacturers would not be used to develop FPs CPI.[139] Manufacturers of other products would have to be found whose operations and market are similar to those of FP. Selection of such manufacturers would be very subjective and could lead to very inaccurate results. The comparable profit method could thus produce a result inconsistent with the arm's length standard, whereas the comparable uncontrolled price method would produce the arm's length price.[140] Therefore, at the very least, the coordinating rule should contain an exception for tangibles that are produced using manufacturing intangibles if the comparable uncontrolled price method would otherwise be applicable to these tangibles.[141]

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[139] If FP's CPI was developed using other toothpick manufacturers, the price of the toothpicks would have to be drastically reduced below the going rate to provide FP with a reported operating income that is within the CPI of other toothpick manufacturers. Economically, this is indefensible; except under exceptional circumstances, an uncontrolled FP seems likely to set its price at, or only slightly below, the market price, regardless of its low manufacturing costs.

[140] If FP's CPI was developed using other toothpick manufacturers, the price of the toothpicks would have to be drastically reduced below the going rate to provide FP with a reported operating income that is within the CPI of other toothpick manufacturers. Economically, this is indefensible; except under exceptional circumstances, an uncontrolled FP seems likely to set its price at, or only slightly below, the market price, regardless of its low manufacturing costs.

[141] Support for this position can, in fact, be found in Example 6 of section 1.482-2(f)(U) of the proposed regulations. That example describes a "round trip" transaction, similar to that in Bausch and Lomb v. Comm'r, supra. A U.S. corporation, DevCo, developed new production techniques for widgets. A foreign subsidiary manufactures the widgets using the new production techniques and sells the widgets to a U.S. subsidiary of DevCo. The example demonstrates now the CPI test is applied to the manufacturing subsidiary to determine whether an arm's length royalty was paid to DevCo for use of the manufacturing techniques. The example, however, mentions mat the price the U.S. subsidiary is charged for the widgets is determined to be the "comparable uncontrolled price within the meaning of paragraph (e)(2) [the tangible rules] of this section."

Thus, although the purpose of the example is to demonstrate the application of the CPI test to intangibles, the example does assume that the tangible rules can be used to determine the price of a tangible that was produced using an intangible. The coordinating rule should be clarified, however, explicitly to allow this approach.

There does not appear to be any policy reason to apply the intangible rules, as such, to any situation in which a tangible is manufactured using an intangible, since, if the comparable uncontrolled price method does not apply, the CPI is still used as a test under any of the other tangible methods. The cost plus and resale price methods are useful tools in establishing a price for tangible goods where comparables do not exist The effect of the coordinating rule would be to allow a manufacturer to ignore these methods as long as its reported operating income falls within the CPI, even though application of the tangible rules would provide for a more accurate result The Committee thus recommends that the coordinating rule not apply to tangibles that are produced with manufacturing intangibles, even if the comparable uncontrolled price method is inapplicable.

Similarly, in cases such as Example 3 of section 1.482-2(f)(11) of the regulations, in which a tangible contains a significant marketing intangible, the coordinating rule is unnecessary and unwarranted. If, due to the unique nature of the marketing intangible, the comparable uncontrolled price method would not apply, the CPI test would be required even under the proposed tangible rules, and the coordinating rule’s main effect would be to render the cost plus and resale price methods inapplicable. If the comparable uncontrolled price method could be applied, the above analysis regarding manufacturing intangibles is equally valid here.

The only circumstance of which the Committee is aware in which the coordinating rule might be important to prevent abuse is where an intangible is disguised as a tangible. If, for example, FP invents a cheap method of producing toothpicks and FP creates a machine that uses this new method and sells the machine to USS, this transfer is really a disguised transfer of the manufacturing intangible. The rules specifically tailored to transfers of intangibles are therefore appropriate. Perhaps the coordinating rule should be narrowed to include only transfers of tangibles that are used for manufacturing and employ significant intangibles. One might argue, however, that, even in this case, the coordinating rule (although unobjectionable) is also unnecessary because the broad definition of intangible in the proposed regulations would already encompass such “disguised” intangibles.

Not only is the coordinating rule unnecessary and sometimes counterproductive, it is also impossible to apply in a predictable manner. The coordinating rule applies to transfers in which “the income attributable to the intangible is material in relation to the income attributable to the tangible property or services.” The term “material” is not defined. Without a definition, the standard is extremely vague. Any definition, however, would either be very difficult to apply or would lead to unacceptable uncertainty.

One possible way to define “material” would be to use a numerical standard. For example, the regulations might state that, if 25 percent of the income from a sale were attributable to an intangible, this income would be “material” Such an approach would make the transfer pricing method circular; a determination of how much income is attributable to the intangible and how much to the tangible would have to be made before applying the pricing methods described in the proposed regulations. If such a precise determination could be made as to how much income is attributable to the tangible and how much to the intangible, there would be little need for this portion of the proposed regulations.

On the other hand, if a subjective definition were to be employed, a taxpayer could never use the tangible rules without risk that the Service might later find a “material” intangible of some sort and apply the intangible rules. As suggested above, this is particularly troublesome with respect to manufacturing intangibles to which the comparable uncontrolled price method would otherwise apply. Almost any competitive manufacturing process could be said to contain know-how, the income from which is “material” in relation to the income attributable to the tangible property or services to which it relates.

Thus, in regard to tangibles, the coordinating rule creates great uncertainty in the application of the pricing rules and serves no positive purpose, except in the case of tangibles that are really disguised intangibles. The Committee therefore recommends that the coordinating rule be narrowly tailored to apply only to the cases in which it is needed.

Location Savings and Section 936

“Location savings” are the savings that an entity realizes by basing its operations in one geographic location rather than another. Such savings include cost differentials due to differences in labor costs, property taxes and costs of capital.[142]

In the case of section 936 companies that manufacture products for direct sales to third parties or to their mainland affiliates, the longstanding position of the Service and the courts has been to allow the location savings realized by the manufacturer in Puerto Rico to remain with the manufacturer.

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142 See Sundstrand Corp. v. Comm’r, supra. For additional comments relating to location savings, see p. 70, infra.

Revenue Procedure 63-10[143] "allocates to the island affiliate all income or loss resulting from the choice of Puerto Rico rather than the United States as a location for manufacturing activity." This is presumably in recognition of the Congressional intent in enacting section 936 that companies which operate under that section should receive special tax benefits.[144]

As stated in Rev. Proc. 63-10:

> The guidelines are based on a recognition that Puerto Rican allocation problems arise in a unique factual context in that the economic relationship between Puerto Rico and the United States has special characteristics. Thus, the close ties between the economies of Puerto Rico and the United States mean that in many respects Puerto Rico is an integral part of the United States market Accordingly, the determination of allocation questions involving pricing aspects in the case of products manufactured in Puerto Rico and sold to United States customers must take this relationship into account, in that these questions may be properly answered only with an approach which is appropriate to questions arising under the particular circumstances involved.

Subsequent to the issuance of Revenue Procedure 63-10, the existing regulations under section 482 were promulgated. In Revenue Procedure 68-22,[145] the Service stated, in recognition of the special characteristics and unique factual relationship between U.S. companies and their manufacturing affiliates in Puerto Rico, that "the Service will continue to close cases on the basis of the guidelines published in Revenue Procedure 63-10 in cases involving allocation of income and deductions between U.S. companies and their manufacturing affiliates in Puerto Rico if the result is more favorable to the taxpayer than the result under the regulations prescribed by Treasury Decision 6952."

[143] 1963-1 C.B. 490.

[144] See also Eli Lily and Co. v. Comm'r, supra.

[145] 1968-1 C.B. 819.

The Tax Equity and Fiscal Responsibility Act of 1982 established various elections that could be made by section 936 companies. Under the cost sharing election contained in section 936(h)(5)(c)(i), the section 936 company is deemed the owner of any manufacturing intangibles and entitled to a return thereon, but is not deemed to be the owner of the marketing intangibles (and is, therefore not entitled to a return thereon). For all other purposes of determining income and loss of the section 936 company and its mainland affiliates, “the regulations under section 482, and Internal Revenue Service revenue procedures (Revenue Procedure 63-10, as exemplified by Revenue Procedure 68¬22) will continue to apply.”[146]

In recent years, the Service and the Treasury Department have been dissatisfied with the cost sharing election, presumably because it allows a full return on manufacturing intangibles to the section 936 company, and also because it still requires the application of section 482. During the Congressional consideration of the tax bill which became the Tax Reform Act of 1986, the Treasury Department proposed the repeal of the section 936(h) cost sharing election, but this was not adopted in the final bill.

Under the proposed regulations, however, the Service, in effect, accomplishes by regulations what it was unable to do by legislation. The proposed regulations are silent on location savings, and appear to override Revenue Procedure 63¬10. Service representatives have informally stated that many or most section 936 companies under the CPI analysis will probably be treated as contract manufacturers, and will be entitled to location savings

[146] Conf. Report No. 97-530, 97th Cong. 2nd Sess. (August 18, 1982); see also, Reg. § 1.936-6(a)(5) Q&A 12.

only if they can show that unrelated purchasers would allow contract manufacturers to retain the income allocable to such savings. This will be an impossible burden for most, if not all, section 936 companies to meet The Service will likely contend that such companies use locations savings only to submit a lower bid, and this necessarily means that the profit element, allocable to the savings, would not remain with the section 936 company.

The Committee therefore recommends that the regulations contain a provision that would allow section 936 companies, which make the cost sharing election, to retain the profit attributable to their location savings. In other words, consistent with Congressional intent (as cited above) in enacting section 936(h), the principles of Revenue Procedure 63-10 would continue to be applicable to section 936 companies which elect the cost sharing method, similar to the announcement made by the Service in Revenue Procedure 68-22 following the promulgation of the existing regulations.

Services

Section 1.482-2(b) of the current regulations provides rules for pricing services performed by one member of a group of controlled entities for another member. The regulation distinguishes between different types of services. The general rule is that an arm’s length charge for services is “deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services unless the taxpayer establishes a more appropriate charge.”[147] Thus, in regard to these services, no profit margin need be recognized.

147 Reg. § 1.482-2(b)(3).

Section 1.482-2(b)(7) of the current regulations, however, provides that profit must be recognized “with respect to services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services.”

The general rule of section 1.482-2(b) of the current regulations that a service provider need not calculate an appropriate profit when it furnishes services lifts a major administrative burden from most, if not all, controlled groups. Members of such groups commonly perform services for other members. These services are often difficult to categorize or to define. It may be impossible to determine the profit that an uncontrolled service provider would require, because similar services would not and could not be performed by uncontrolled entities. The cost of providing these services is obviously much easier to determine.

In contrast, the services described in section 1.482-2(b)(7) of the current regulations are more likely to be performed in uncontrolled circumstances. Certainly, if the service provider provides similar services for uncontrolled entities, this would be a ready source of comparables. Also, if the provision of these services is an integral part of the business activity of the provider, there is at least a reasonable possibility that similar uncontrolled firms exist that perform similar services as an integral part of their business activities. In these situations, determining an appropriate profit margin is less burdensome.

However, section 1.482-2(d)(1)(iii) of the proposed regulations would apply the intangible rules wherever a “material” intangible is contained in a service, regardless of whether the service falls under the special rule of section 1.482-2(b)(7) of the current regulations. This would eliminate the distinction in the current regulations between services that are an integral part of the business activity of either party and all other services. It would place a tremendous burden on controlled entities, which in order to calculate a CPI would have to search, often in vain, for uncontrolled entities that provide similar miscellaneous services.

The Committee recommends that services not described in section 1.482- 2(b)(7) of the current regulations continue to be governed by section 1.482-2(b)(3)-(6) of the current regulations, even if such services involve the transfer of significant intangibles. The commensurate-with-income standard should not be applied to such services. The same reasons why the Committee believes that the Service lacks the statutory authority to apply CPI to tangibles apply also to services. However, if the Service concludes that statutory authority does exist, the Committee suggests that the same rules proposed for transfers of intangibles might be applied to transfers of services described in section 1.482- 2(b)(7) of the current regulations.

The line between intangibles and services is often very difficult to draw. The definition of "intangible" provided by section 1.482-2(d)(1)(ii)(A) of the proposed regulations seeks to distinguish between intangibles and certain kinds of services by stating that "the term intangible means any of the following items that have substantial value independent of the services of any individual." (Emphasis added.) The meaning of this phrase is unclear.[148] If the proposed regulations have different rules for

[148] This language first appeared in the regulations under section 482 in 1968. It was also incorporated into section 936(h)(3)(B) m 1982. There is practically no authority, however, under either section 482 or section 936 that sheds light on its meaning.

transfers of services and intangibles, complicated guidelines would be required to distinguish between these two types of transfers.

A simpler approach would be to apply the same rules to intangibles and to services described in section 1.482-2(b)(7) of the current regulations. For either type of transfer, the matching transaction method would be applied if appropriate, without the requirement of a CPI test. If that method could not be applied, the comparable adjustable transaction method with the CPI test would be applied, if appropriate, and if not, the comparable profit method would be applied. Consistent with our general recommendation, if the tested party’s income falls within the CPI, it could not be challenged by the Service; however, in cases where it falls outside of the CPI, the taxpayer would have to prove the correctness of its transfer pricing. For services not described in section 1.482-2(b)(7) of the current regulations, the rules of section 1.482-2(b)(3)-(6) of the current regulations would continue to apply.

Other Suggestions

With respect to transfers of tangible property, the CPI should not be mandated to be utilized in connection with the application of the resale and cost plus methods; however, similar to our suggestion with respect to intangibles, the CPI either could be a “fourth method” or an elective safe harbor in connection with the application of the resale price or cost plus methods. The CPI should be a fourth method, but there should not be a requirement that income resulting from transfer pricing utilizing that or another methodology be at the most appropriate point of the interval; rather, if the income folk anywhere within the interval it would be eligible for the safe harbor described above, while if it falls outside of the interval, the Service could challenge the methodology, subject to rebuttal by the taxpayer.

Section 1.482-2(f)

Summary of Proposed Regulations

General

The CPI is a range of profits that a controlled taxpayer (the "tested party") would have earned from a "controlled transfer" of intangible or tangible property if such taxpayer had determined its profitability by using objective measures of profitability ("profit level indicators") derived generally from similarly situated uncontrolled taxpayers engaging in comparable uncontrolled transfers.[149] To determine the CPI, profit level indicators derived from similarly situated uncontrolled taxpayers are applied to the financial data of the tested party to recalculate its operating income ("constructive operating income").[150] The CPI is then constructed by selecting amounts of constructive operating incomes that converge to form an interval that is reasonably restricted in size.[151]

Operating Rules

Generally, the CPI is to be constructed based on actual, rather than projected, results for the three-year period that includes the taxable year under review, the preceding year and the following year, unless circumstances indicate that a

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149 Prop. Reg. § 1.482-2(f)(1).

150 Id.

151 Id.

different period is more appropriate.[152] Specifically, there are six steps in developing the CPI:

Step 1: Select the party to a controlled transaction to be tested.[153] The tested party is the party to the controlled transaction whose "operating income" is to be tested. Which controlled taxpayer is selected as the tested party depends on whose operating income can be verified using the most reliable data and by making the fewest and most accurately quantifiable adjustments.[154] This, in turn, depends on the nature of the transaction and the transfer pricing method to be validated by the CPI.[155] For example, in the case of a transfer of an intangible, the tested party ordinarily would be the transferee.[156] In the case of a transfer of tangible property, the tested party ordinarily would be the buyer if the resale price method is being used and the seller if the cost plus method is being used.[157]

Step 2: Determine the applicable business classification of the tested party.[158] The term "applicable business classification" is the broadest category of operations of the tested party that relates to the controlled transaction under

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[152] Prop. Reg. § 1.482-2(f)(2).

[153] Prop. Reg. § 1.482-2(f)(4).

[154] Prop. Reg. § 1.482-2(f)(4)(ii).

[155] Id.

[156] Id.

[157] Id.

[158] Prop. Reg. § 1.482-2(f)(5).

review.[159] Its determination involves (a) identifying the operations of the tested party that relate to the controlled transaction under review (the “tested operations”) and (b) matching as closely as possible the tested operations to similar operations of uncontrolled taxpayers, based on the most reliable data available.[160]

If possible, operations of uncontrolled taxpayers are selected that closely correspond to the tested operations, Le., by reference to products and functions.[161] If that is not possible, then the scope of the applicable business classification may be broadened if there is sufficient reliable data relating to the broader classification, or the tested party’s operations may be divided into separate categories to permit proper matching of the tested party’s results to those of similarly situated uncontrolled taxpayers engaging in uncontrolled transactions.[162]

Step 3: Compute constructive operating incomes.[163] The “constructive operating income” is the tested party’s operating income recalculated by applying profit level indicators obtained from a selection of uncontrolled taxpayers in the applicable business classification to the financial data of the tested party.[164]

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159 Prop. Reg. § 1.482-2(f)(5)(iii).

160 Prop. Reg. § 1.482-2(f)(5)(i).

161 Prop. Reg. § 1.482-2(f)(5)(ii).

162 Id.

163 Prop. Reg. § 1.482-2(f)(6).

164 Prop. Reg. § 1.482-2(f)(6)(i).

The selection of profit level indicators depends upon two interdependent factors: (a) the extent to which reliable data is available concerning similar uncontrolled taxpayers and (b) the extent to which a particular profit level indicator provides a reliable basis for comparing profits of controlled and uncontrolled taxpayers under the specific facts.[165]

A variety of different profit level indicators can be calculated in any given case.[166] Profit level indicators include a rate of return on assets (the ratio of operating income to total assets), margins that divide income and costs in different ways (such as the ratio of operating income to sales or the ratio of gross income to operating expenses) or, in limited cases, comparable profits splits, based either on total operating profits or residual operating profits.[167]

Prior to applying profit level indicators to the relevant financial data of the tested party, the data must be adjusted to reflect (a) allocations under section 482 (other than adjustments made under the intangibles or tangible goods sections of the proposed regulations) and (b) any significant differences between the assets of the tested party and the assets of the uncontrolled taxpayers, such as differences in the relative amount of financial assets or inventory held.[168]

Step 4: Determine the CPI.[169] The CPI is constructed by selecting those amounts of constructive operating income

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[165] Id.

[166] Prop. Reg. § 1.482-2(f)(6)(iii)(A).

[167] Prop. Reg. § 1.482-2(f)(6)(iii)(C).

[168] Prop. Reg. § 1.482-2(f)(6)(iv)(B).

[169] Prop. Reg. § 1.482-2(f)(7).

(determined in step three above) that converge to form an interval that is reasonably restricted in size.[170] Data that diverges significantly from other data is excluded from the interval.[171]

If there is a small number of uncontrolled taxpayers whose operations correspond closely to the applicable business classification, two types of convergence should be considered in constructing the CPI.[172] The first is convergence of constructive operating incomes of the tested party derived from several profit level indicators of a single uncontrolled taxpayer.[173] The second is convergence of constructive operating incomes derived from one or more profit level indicators obtained from multiple uncontrolled taxpayers.[174] In determining both types of convergence, the reliability of the data must be considered and greater weight accorded to data that is more reliable.[175]

If the number of uncontrolled taxpayers whose operations correspond to the applicable business classification is large enough to permit the use of valid statistical techniques, then convergence must be determined by using those techniques to identify a reasonably narrow area of concentration among all of the constructive operating incomes computed.[176]

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[170] Id.

[171] Id.

[172] Id.

[173] Id.

[174] Id.

[175] Id.

[176] Id.

Step 5: Determine the most appropriate point in the CPI.[177] Where the results reported by a controlled taxpayer are outside the CPI, it generally will be necessary to identify the most appropriate point within the CPL[178] If statistical techniques are not used to construct the CPI, the most appropriate point is determined by considering a number of factors relating to the comparability and reliability of the underlying data.[179] If statistical techniques are used to construct the CPI, then the most appropriate point is determined using statistical measures of “central tendency.[180]

Step 6: Determine the transfer price for the controlled transaction.[181] The transfer price is determined by adjusting the actual charge in the controlled transaction to produce an operating income for the tested party that equals the constructive operating income corresponding to the most appropriate point in the interval.[182]

Comments

General

The use of the CPI is an innovative concept The Committee commends the Service for proposing that there is a range (i.e., more precisely, an interval) of acceptable transfer prices and that transfer pricing should be examined by reference

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177 Prop. Reg. § 1.482-2(f)(8).

178 Id.

179 Id.

180 Id.

181 Prop. Reg. § 1.482-2(f)(9).

182 Id.

to the results over a period of years to reflect business cycles. The Committee also commends the Service for attempting to formulate more objective procedures for determining whether transfer prices are arm’s length. These procedures are an attempt by the Service to provide certainty in result and thereby avoid one of the nettlesome problems of the current section 482 regulations. If a controlled taxpayer’s profits fall within the interval, the Service generally will not adjust the transfer pricing under review. On the other hand, if a controlled taxpayer’s profits do not fall within the interval, then the controlled taxpayer knows generally what the resultant consequences will be. Unfortunately, the foregoing mentioned certainty of result is premised on an assumption that taxpayers and the Service will be able to agree on the overall construction and results of the CPL

Deficiencies in CPI

Standardization of Profit. The way the CPI is constructed has the effect of standardizing a controlled taxpayer’s rates of return by reference to those of uncontrolled parties. However, the fact that a controlled taxpayer’s profits may vary from those of uncontrolled parties should not necessarily be treated as due to deficiencies in the controlled taxpayer’s transfer pricing. A company’s financial performance is due to a variety of external (e.g., currency fluctuation, cost of equity, competition, quality, etc.) and internal (e.g., management skill, efficiency, etc.) factors and may be better or worse than the rate of return of uncontrolled taxpayers, depending on those factors, completely apart from its transfer pricing decisions. The proposed regulations do not take this into account in arriving at the CPI.

Contrary to Legislative History. The validation or determination of transfer pricing by reference to an interval of a controlled party's operating income, computed by reference to profit level indicators of uncontrolled parties, is not in conformance with the legislative intent underlying the commensurate with income standard. The principal Congressional concern underlying the amendment related to the fact that it was the perception of Congress that insufficient income was being allocated to the transferor of high profit intangibles, mainly because "taxpayers frequently have taken the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items."[183] Utilization of profit level indicators of uncontrolled parties' that may be performing functions or incurring risks dissimilar to that of the tested party to validate controlled parties' transfer pricing would appear to be in direct contradiction to Congressional concerns against utilizing standardized rates and not closely comparable transactions to establish transfer prices. Thus, the Committee believes that the concept of the CPI as the cornerstone of the transfer pricing system for intangible and tangible property is not in conformance with the legislative intent of the 1986 Act

De-Emphasis of Transactional Comparability. The use of the CPI reduces the importance of a transactional approach to pricing, while emphasizing a profits analysis Under the CPI methodology, the arm's length nature of a controlled transfer is validated by reference to one of the controlled parties to the transaction, Le., the tested party, and the transfer is treated as arm's length if the tested party's operating income, or reported operating income, as the case may be, falls within the

183 Blue Book, at 1014 (1987).

CPI. This approach implicitly assumes that if the tested party's profits are validated by the CPI, the other controlled taxpayer necessarily will also derive an arm's length amount This represents a radical departure from current rules and practices under which it is common to verify the reasonableness of a transfer pricing method by determining whether there is a fair division of the profits between the two controlled parties. Moreover, because the CPI limits the use of profit split comparisons, taxpayers and the Service will be limited in their ability to deal with many situations, especially where both controlled parties own valuable intangibles.

Clear Reflection of Income. The Committee has serious concerns as to whether the CPI will in most cases clearly reflect the incomes of both of the controlled parties to the transaction, particularly where no inquiry is made as to whether the transfer pricing results in a reasonable allocation to the other controlled taxpayer participating in the controlled transaction. Under a CPI analysis, it is possible that more income could be allocated to the tested party than exists in respect of the overall transaction of the controlled parties being tested. Aside from the CPFs exclusion of the other party to the transfer from the analysis, the Committee has serious concerns over whether the CPI mechanism itself, even if sufficient information can be found for the CPI to be applied, produces comparable transfer prices. The mere fact that data converges does not mean that the results are comparable.

Data. A major problem arises from the CPI's reliance on third party data. The proposed regulations provide no guidance as to how a taxpayer might obtain such data for purposes of making transfer pricing decisions. It was anticipated that a portion of the Service's report to Congress on the operation of section 482 would be devoted to explaining how the Service proposes that third-party information be obtained (and protected from unauthorized disclosure) for purposes of performing the necessary analyses required by the proposed regulations. However, the IRS § 482 Report merely states that the Service plans to work with interested parties to determine mechanisms to protect voluntarily submitted information.[184]

The Committee is aware that under the direction of the Commissioner’s Advisory Group a Task Force on Third Party Transfer Price Information has been formed to explore the availability of data based in the United States and abroad, and to consider what data is needed and how to secure such data. The Committee commends this effort. Obviously, the availability of reliable data is crucial to the operation of the proposed regulations in their current (or in a revised) form and the Committee awaits the outcome of the study with great interest

Subjectivity. The Committee commends the Service for its attempt to formulate an objective standard against which transfer pricing can be measured. Nevertheless, while on its face the derivation of the CPI appears to be objective, in practice numerous subjective judgments must be made to derive the CPI. Virtually every step in the development of the CPI requires the taxpayer and the Service to make subjective decisions with respect to which the proposed regulations provide no guidance. The following are a number of instances where the Committee believes the proposed regulations do not provide adequate guidance.

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[184] IRS § 482 Report at 1-7. See also Peterson Testimony, at 9.

There is no guidance as to how the selection of the tested party is to be made in a transfer pricing situation involving the sale of goods where each controlled party owns valuable intangibles. In cases where it is not possible to show similarity to a tested party on a reasonably narrow level, the proposed regulations state that a broader applicable business classification can be utilized or the functions of the tested party can be divided and compared on a functional basis, though the proposed regulations provide no guidance as to how this is accomplished. Additionally, the proposed regulations simply ignore the possibility that an applicable business classification cannot be found and, accordingly, no guidance is provided for such case. The proposed regulations do not provide guidance as to how a convergence of constructive operating incomes is determined.[185] In this same regard, while the proposed regulations contemplate the use of valid statistical techniques for determining convergence when the number of uncontrolled taxpayers whose operations correspond to the applicable business classification is large enough, the proposed regulations do not elaborate on the statistical techniques to employ. Finally, the proposed regulations provide no guidance as to what constitutes either an interval or central tendency for purposes of determining the most appropriate point[186]

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[185] In the example provided by the proposed regulations, the CPI was determined by using a particular four of eight uncontrolled taxpayers. Depending upon the facts and circumstances, however, there could be any number of reasons why a different group of the eight, rather than the particular four, could have been used, with potentially very different results. Taxpayers and the Service are likely to dispute which are the relevant uncontrolled taxpayers to use. Prop. Reg. § 1.482-2(f)(11)(example 3).

[186] The mean or average is the most often cited measure of central tendency, though it is only one of several such measures and may sometimes be misleading because it is sensitive to extreme values in a group.

Thus, under the proposed regulations, not only would there continue to be controversy over whether a transfer price is arm's length but, as illustrated above, there would be additional controversy as to how to compile and interpret the relevant data.

Usefulness of Proposed Regulations in Planning

While the approach of the proposed regulations to using data from multiple years is commendable, the proposed regulations' implementation of this concept renders the proposed regulations of little use to taxpayers in making prospective pricing decisions. Generally, under the proposed regulations, actual data must be obtained for a three-year period that includes the taxable year under review, the preceding year, and the following year. While data for this span of years possibly may be available in an audit situation, it certainly would not be fully available in a planning situation, thus necessitating the use of projections, rather than actual results, for some of the years. Thus, the proposed regulations can be used by a taxpayer only by means of ongoing amended returns to reflect subsequently obtained CPI information,[187] resulting in duplication and administrative inconvenience. As an alternative, a taxpayer could make adjustments in the year after the pricing decision so as to have an appropriate three year average, assuming that such an appropriate average can be determined. Such an adjustment in the third year, however, would have a distortive effect on

[187] This assumes, of course, that such CPI information will be available within a time frame to allow the timely filing of an amended return. This conclusion further assumes that the regulations would permit taxpayers to amend their returns. See Reg. § 1.482- 1(b)(3). To the extent the CPI is retained in final regulations and includes data for future years, the Service should make clear that Reg. § 1.482-1(b)(3) will not be invoked by the Service in cases where taxpayers refine their pricing as a result of using the CPL Under the Committee's recommendation, infra, this issue would not arise because prior years data would be utilized.

determining the pricing for the next year (which itself will look at a three-year period which includes the year in which the adjustment is made). Accordingly, while the Committee agrees in concept with the use of multiple years to evaluate the correctness of transfer prices, as implemented by the proposed regulations, a taxpayer is precluded from relying on the regulations to make such decisions.

Recommendations

In view of the standard of section 482, controlled party transfer pricing should be market (and not tax) driven. Accordingly, the CPI should not be the mandatory system for determining transfer prices. Instead, the validity of transfer prices should be determined based on facts and circumstances, of which the CPI is but one factor.

If the CPI mechanism is to be retained, however, it should be available only as another method or as an elective safe harbor. If retained as another method, it should be based on data for the three years prior to the year of transfer and have a priority below an uncontrolled transaction that is an exact comparable. If adopted as a safe harbor, we suggest that to the extent that a taxpayer’s income from the transfer of intangible or tangible property falls within the CPI (as agreed upon by the taxpayer and the Service), determined for the three years prior to the year of transfer, then such taxpayer’s transfer pricing methodology could not be challenged by the Service. On the other hand, if a taxpayer’s income from the transfer of intangible or tangible property is not within the CPI for the three years prior to the year of transfer, then such taxpayer’s transfer pricing could be challenged, though the taxpayer would have a rebuttal opportunity.

Also, the Service should modify the proposed regulations to permit the use of a profit split analysis, particularly to deal with the case where both controlled parties have valuable intangibles. Under this approach, the profit or loss to the related entities from the transaction or transactions would be determined, followed by a determination of the appropriate allocation of the overall profit or loss to the related parties. In applying the methodology, the taxpayer would be required to justify how it apportioned profits by reference to the objective circumstances of the transaction in order to respond to the concerns of the Service.

Other Comments

While the Committee views the CPI concept as set forth in the proposed regulations to be seriously flawed, if it is continued in the final regulations the issues raised above should be addressed in order to enable taxpayers and the Service to have some degree of certainty in constructing the CPI. In addition, we suggest the following changes.

Financial Data to Validate Tax Data. The proposed regulations do not fully rationalize the use of financial data to validate tax data. The CPI is constructed by reference to financial data obtained from uncontrolled taxpayers, which data is then applied to the financial data of controlled taxpayers. The sole purpose of the CPI under the proposed regulations, however, is to validate (or determine) transfer prices for tax purposes. In the context of that objective, the proposed regulations do not appear to fully take into account the fact that financial data and tax data may not necessarily be computed in a similar manner or conform in result, absent making certain adjustments. For example, in computing operating income, the proposed regulations do not provide guidance as to how one should reflect differences in the derivation of financial and tax income. It would be useful for the Service to explain in more detail how financial data should be used in validating (or determining) tax data. Moreover, it is unclear what weight should be given to financial data of a taxpayer when that taxpayer is under audit and the Service is proposing adjustments. This problem is compounded because the tested party would most likely be unaware of the on-going audit

Risks. For purposes of determining the applicable business classification of the tested party, in selecting uncontrolled taxpayers' operations which closely correspond to the tested operations the proposed regulations refer only to products and functions. Corresponding type risks should also be a factor in such determination since risk is a significant factor in all pricing decisions.

Location Savings. The proposed regulations allow the utilization of comparable third-party data from a jurisdiction other than the one in which the controlled taxpayer conducts business if reliable data does not exist for the jurisdiction in which the controlled taxpayer operates. If comparable third-party data can only be obtained from a high cost jurisdiction, but is applied to compute the CPI for the tested party in a low cost jurisdiction, the regulations should address how one makes adjustments for location and other types of savings. The Service should not seek to eliminate the benefits of location savings by using data as currently proposed.

Comparability of Profit Level Indicators. The selection of profit level indicators and the required adjustments to the financial data provided for in the proposed regulations may not practically result in sufficient comparability.

Adjustments. The return on assets analysis should acknowledge the effects of inflation and currency adjustments on the value of the assets. Also, unless assets are adjusted somehow to current market values, recent asset investments will show poorer returns than older asset investments and lessors will have better returns than purchasers. Additionally, adjustments should be made to reflect that taxpayers who have engaged in sale-and-leasebacks may show different asset ratios and that a taxpayer’s large current asset acquisitions will also depress the return on assets ratio at the same time that accelerated depreciation reduces taxable income.

The regulations should address how adjustments will be made to reflect differences in foreign data to U.S. GAAP and how adjustments for data in non-functional currencies will be reflected.

Section 1.482-2(g)

Under a cost sharing arrangement the participants share in the costs of research and development and can utilize the intangibles developed therefrom without the payment of any additional consideration. The proposed regulations provide that, if a taxpayer is an “eligible participant” in a “qualified cost sharing arrangement,” the Service may make allocations with respect to such participant only under the cost sharing rules described below and not under the general rules relating to transfers of intangibles described above. If the participant is not an eligible participant or the arrangement is not a qualified cost sharing arrangement, the general rules relating to transfers of intangibles apply.

Summary of Proposed Regulations

General Requirements

A "qualified cost sharing arrangement"[188] must:

1. include two or more "eligible participants";

2. be recorded in writing contemporaneously with its formation;

3. provide for the sharing among eligible participants of the costs and risks borne by any participant of developing one or more intangibles[189] in return for a specified interest in any intangible[190] that may be produced;

4. reflect a reasonable effort by each eligible participant to share all of the costs and risks of intangible development, including the costs and risks of unsuccessful or less successful related development, such that each eligible participant's share of the cost and risks is proportionate to the benefits that each eligible participant reasonably anticipates it

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188 Prop. Reg. § 1.482-2(g)(2)(i).

189 For this purpose, costs include all of the direct and indirect costs related to the intangible development area. Prop. Reg. § 1.482-2(g)(7)(ii). The intangible development area is a classification of products or services with respect to which intangible development is conducted under a qualified cost sharing agreement Prop. Reg. S 1.482-2(g)(4)(i)(A).

190 The term "a specified interest in any intangible" means a legally enforceable interest the benefits of which are susceptible of valuation and which would ordinarily be transferred between uncontrolled taxpayers acting at arm's length under an arrangement to share the costs of developing intangibles. Prop. Reg. S 1.482-2(g)(7)(i).

will receive from the exploitation of intangibles developed under the arrangement; and

5. meet certain administrative requirements: (a) the material provisions[191] of the arrangement must be recorded as required in condition two above and(b) any change to a material provision must be recorded in writing and reported by the eligible participants.

An arrangement establishes a method reflecting the reasonable effort described in the fourth requirement only if it contains a mandatory mechanism to adjust shared costs to account for changes in economic conditions, the business operations and practices of the participants and the ongoing development of intangibles under the arrangement (the “periodic adjustment requirement”).[192] The proposed regulations require that such adjustments generally be made on an annual basis.[193]

For purposes of allocating the costs and risks of developing an intangible, anticipated benefit from the intangible may be measured in several different ways, so long as the measure

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[191] The material provisions of a cost sharing arrangement are as follows: (1) identification of the arrangement’s participants ; (2) the duration of the arrangement; (3) the intangible development areas covered by the arrangement; (4) the arrangement’s method for dividing costs of developing intangibles; (5) the extent to which a tangible or intangible property not developed under the arrangement is made available to the participants for use in the arrangement; (6) the extent to which any entity other than an eligible participant is permitted to use intangibles developed under the arrangement; (7) whether any participant has received an exclusive right to use developed intangibles (such as an exclusive right to manufacture particular products or an exclusive right to sell products in a particular geographic area) and, if so, the nature of that right; (8) the conditions under which the arrangement may be modified or terminated; and (9) the general administrative provisions of the arrangement Prop. Reg. § 1.482-2(g)(6)(iii).

[192] Prop. Reg. § 1.482-2(g)(ii)(B).

[193] Id.

reasonably predicts the benefits to be shared.[194] Methods include references to units of production, sales, and gross or net profits.[195]

Eligible Participant Rules

An eligible participant is a member of a group of controlled taxpayers that agrees to participate in a qualified cost sharing arrangement only if intangibles developed under the arrangement are, or will be, used in the active conduct of the participant's trade or business and if the participant meets certain administrative requirements.[196] For purposes of the active trade or business requirement, activities may be carried out on behalf of the participant by independent contractors, provided that the participant bears the economic risks and receives the benefits of those activities.[197] Also, one member of a group of controlled taxpayers may participate in cost sharing arrangements on behalf of one or more other members of the group (the "cost sharing subgroup").[198] However, an intangible is not considered under the proposed regulations to be used in the active conduct of a participant's trade or business if a substantial purpose for

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[194] Prop. Reg. § 1.482-2(g)(2)(ii)(A).

[195] Id.

[196] Prop. Reg. § 1.482-2(g)(3)(i). A participant meets the administrative requirements if the participant substantially complies with each of the following rules: (a) the material provisions or the arrangement are made available to the Service; (b) the participant maintains records sufficient to verify (i) the material provisions of the arrangement, (ii) the amount of the costs borne under the arrangement and (iii) the computation of the participant's operating income resulting from the arrangement, and (c) the records are timely produced by the participant if requested by the Service. Prop. Reg. § 1.482- 2(g)(6)(ii).

[197] Prop. Reg. § 1.482-2(g)(3)(iii).

[198] Prop. Reg. S 1.482-2(g)(3)(v)(A). Any intangible acquired pursuant to a qualified cost sharing arrangement in which a cost sharing subgroup is treated as a single eligible participant will be considered acquired

participating in the arrangement is to obtain an intangible to transfer to an uncontrolled taxpayer.[199] Such a purpose will be presumed if there are any significant direct or indirect transfers of intangibles to an uncontrolled taxpayer during the course of the arrangement or within four years after its termination.[200]

Allocations, Recharacterizations and Disqualifications

The Service may make allocations to insure that the intangible development area encompassed by the arrangement is appropriate[201] and to insure that the method for sharing costs is an appropriate measure of the benefits reasonably anticipated by each participant.[202]

Intangible Development Area. If the intangible development area encompassed by the arrangement is too broad or too narrow, an adjustment of the participant's cost share may be made.[203] An intangible development area will be deemed to be too broad if any participant will not be able to use developed intangibles in its active business and will be deemed to be too narrow if it does not encompass all "related" intangible

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solely by the member participating in the arrangement on behalf of the cost sharing subgroup. Prop. Reg. § 1.482-2(g)(3)(v)(B).

199 Prop. Reg. S 1.482-2(g)(3)(iv)(A).

200 Id.

201 Prop. Reg. § 1.482-2(g)(4)(i).

202 Prop. Reg. § 1.482-2(g)(4)(ii).

203 Prop. Reg. § 1.482-2(g)(4)(i)(A).

development.[204] In either of these two cases, an allocation made by the Service must be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year.[205] An appropriate charge for interest also may be made.[206]

Method for Sharing Costs. If the method used by the cost sharing arrangement is not deemed, under the rules described below, to be an appropriate measure of the benefits reasonably anticipated by each eligible participant, the Service may take one of three courses of action, depending on the egregiousness of the perceived failure to accurately match costs and benefits. The applicable course of action is determined generally by a comparison of the U.S. participant's cost/income ratio and the cost/income ratio of the other participants. The cost/income ratio is generally the participant's average cost share (for the current year and the prior two years) divided by its average for the same period of operating income attributable to developed

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[204] Id. Related intangible development is defined to consist of all intangible development of any product or service in the stated intangible development area without regard to whether such products or services are ever successfully developed or sold. It includes research and activity relating to similar products or services. Prop. Reg. § 1.482- 2(g)(4)(i)(B). Similarity, in such cases, is to be determined by "all facts and circumstances that demonstrate the practical or scientific relationship" between the development activities and the products or services. 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 that includes such products or services.

[205] Prop. Reg. § 1.482-2(g)(4)(iii).

[206] Id. It should be noted that, although this timing and interest rule is cross-referenced in section 1.482-2(g)(4)(i)(B) of the proposed regulations and section 1.482-2(g)(4)(i)(C) of the proposed regulations to support the statements in the text, by its terms the rule only applies to adjustments required under section 1.482-2(g)(4)(ii)(B) of the proposed regulations. This presumed drafting error should be corrected m the final regulations.

intangibles.[207] However, different periods for cost, income or both may be used if amounts from such periods more clearly reflect the relationship between the cost of developing intangibles and operating income attributable to intangibles developed under the arrangement[208]

If the cost/income ratio of a U.S. participant is not “substantially disproportionate” to the cost/income ratio of the other participants, any adjustment more closely to match costs with benefits will be limited to an adjustment of the participant’s cost share.[209] A U.S. participant’s cost/income ratio will not be considered substantially disproportionate if it is less than twice the cost/income ratio of the other eligible participants (the “proportionate profits” rule).[210] An allocation made by the Service where ratios are not substantially disproportionate must be included in income in the taxable year under review, even if the costs to be allocated were incurred in a prior taxable year.[211] An appropriate charge for interest also may be made.[212] The substantially disproportionate test does not allow for benefits other than income to be substituted when comparing ratios. If the cost/income ratio of a U.S. participant is “substantially disproportionate” to the cost/income ratio of the other participants, the cost sharing arrangement may be recharacterized in part as a transfer of an intangible outside

[207] Prop. Reg. § 1.482-2(g)(2)(ii)(C)(2).

[208] Id.

[209] Prop. Reg. § 1.482-2(g)(4)(ii)(B).

[210] Prop. Reg. § 1.482-2(g)(4)(ii)(D).

[211] Prop. Reg. § 1.482-2(g)(4)(iii).

[212] Id.

the scope of the arrangement.[213] In the case of such a recharacterization, a “buy-in” or “buy-out” payment (described below) may be required to reflect arm’s-length consideration for that portion of the intangible deemed to have been transferred. The portion of the intangible deemed to have been transferred generally 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 unless another method is more reliable.[214] As stated above, the substantially disproportionate test does not allow for benefits other than income to be substituted when comparing ratios.

If the cost/income ratio of a U.S. participant is “grossly disproportionate” to the cost/income ratio of the other participants, the method for dividing cost shares will be presumed not to reflect a reasonable effort to share costs in proportion to benefits.[215] Consequently, the cost sharing arrangement will not be considered a qualified cost sharing arrangement. In such a case, the proposed regulations’ general rules relating to the transfer of intangibles apply.[216] The grossly disproportionate test allows a taxpayer to rebut the disqualification presumption by establishing that the method used in the arrangement provides a reasonably accurate measure of benefits.[217] As such, the grossly disproportionate test does allow for benefits other than income to be substituted when comparing ratios. There is no definition in the proposed regulations of the term “grossly disproportionate.”

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213 Prop. Reg. § 1.482-2(g)(4)(ii)(C).

214 Id.

215 Prop. Reg. § 1.482-2(g)(2)(ii)(C)(1).

216 See Prop. Reg. § 1.482-2(d).

217 Prop. Reg. § 1.482-2(g)(2)(ii)(C)(1).

Buy-Ins and Buy-Outs

If an eligible participant in a qualified cost sharing arrangement transfers an intangible it owns to another member of the controlled group, an arm's-length consideration for the transfer must be determined.[218] Such a transfer may occur, for example, if the intangible is developed outside of the arrangement, if the intangible is developed inside the arrangement but transferred to a new participant in the arrangement, or if the intangible is developed inside the arrangement but additional rights are transferred to existing participants upon the departure of a participant[219] Once a relinquishment occurs by such a departing member it may no longer exploit the rights to any intangible unless it pays the remaining participants an arm's-length consideration.[220] In addition, the Service may make an allocation to reflect compensation that should have been paid to a member for assistance rendered in the development of the intangible.[221] The payment in a buy-in or a buy-out may take the form of a lump sum payment installment payment or royalty.[222]

Character of Payments

Payments made pursuant to a qualified cost sharing arrangement will be characterized as costs of developing intangibles of the payor and reimbursements of such costs to the

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218 Prop. Reg. § 1.482-2(g)(4)(iv)(A). For clarity, the final regulations should refer to "another participant in the cost sharing arrangement," not "another member of the controlled group."

219 Id.

220 Prop. Reg. § 1.482-2(g)(4)(iv)(C).

221 Prop. Reg. § 1.482-2(g)(4)(iv)(A); see also Prop. Reg. § 1.482-2(d)(8).

222 Prop. Reg. § 1.482-2(g)(4)(iv)(B)

payee.[223] Any payment made or received by a taxpayer pursuant to an arrangement that the Service determines not to be a qualified cost sharing agreement or a payment made or received pursuant to a buy-in or a buy-out will be considered a payment in consideration for the transfer of an intangible property subject to the provisions of the regulations dealing with intangible transfers.[224]

Comments

General

We believe that it is worth devoting substantial effort to perfecting the cost sharing rules since they offer a major benefit in terms of avoiding complex ex post transfer pricing disputes. Indeed, as the experience under section 936 demonstrates, mandatory cost sharing may be the only way to deal with the strong potential for abuse where high profit "super intangibles" are involved. The proposed cost sharing regulations represent a good faith effort on the part of the Service to address substantial taxpayer concerns raised by the cost sharing proposals and discussion of the White Paper. For instance, under the proposed regulations, cost sharing applies to both manufacturing and marketing intangibles, non-manufacturers can be participants in cost sharing arrangements, a cost sharer's interest in the resulting intangibles have been broadened, a buy-in for good will is no longer required, and existing bona fide cost sharing agreements can more easily qualify. The Committed believes, however, that in many respects the proposed regulations continue to represent an over-reaction to a largely non-abusive practice.

[223] Prop. Reg. § 1.482-2(g)(5).

[224] Id.

Allocation, Recharacterization and Disqualification Standards, Including the Periodic Adjustment Requirement

Under the proposed regulations, a cost sharing arrangement will be considered a transfer of intangibles subject to the intangible provisions of the proposed regulations unless the arrangement establishes a method that reflects a reasonable effort to share the costs of developing intangibles in proportion to the benefits that each eligible participant anticipates it will receive from the exploitation of intangibles developed under the arrangement[225] A method will be deemed to reflect a reasonable effort to share costs in proportion to benefits only if it provides that the costs shared by each eligible participant must be adjusted to account for changes in economic conditions, the business operations and practices of the participants and the ongoing development of intangibles under the arrangement[226] These adjustments “should generally” be made on an annual basis and must insure that the method continues to reflect a reasonable effort to share costs in proportion to benefits over time.[227]

The proposed regulations also state that a method of allocation will be presumed not to reflect a reasonable effort to share costs in proportion to benefits if a U.S. participant’s cost/income ratio is “grossly” disproportionate to the cost/income ratio of all other eligible participants. If a U.S. participant’s cost/income ratio is “substantially” disproportionate compared to that of the other participants, the Service is empowered to recharacterize in part a cost sharing

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[225] Prop. Reg. § 1.482-2(g)(2)(ii)(A).

[226] Prop. Reg. § 1.482-2(g)(2)(ii)(B).

[227] Id.

arrangement as a transfer of an intangible outside the scope of the arrangement Even where the U.S. participant’s cost/income ratio is not substantially disproportionate, the Service is empowered to make adjustments.

The Committee believes that this regime raises a number of questions. First, the Committee believes that the periodic adjustment requirement, while having some logical support in the notion that parties dealing at arm’s length would likely renegotiate an agreement which is grossly one sided in practice, has no apparent statutory basis and may be inconsistent with the arm’s length standard and the prevailing case law. Second, the Committee believes that “proportionate profits rule,” in appropriate cases, should be based on measures of an intangible’s benefit to a taxpayer other than income. Third, the Committee disagrees with the manner in which the “grossly disproportionate” test is applied, its theoretical underpinning and the decision not to provide a safe harbor to help define the term.

The standard by which to measure cost sharing arrangements is the arm’s length standard.[228] The Committee is not aware of any cost sharing arrangements negotiated at arm’s length among uncontrolled persons that provide that cost shares are to be adjusted to match unforeseen benefits realized by such persons in the arrangement, although we are aware of cases where ad hoc adjustments have been made after the fact. Because cost sharing arrangements between uncontrolled parties typically do not contain periodic adjustment clauses, the strict periodic adjustment requirement appears inconsistent with the arm’s length

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[228] See Organization for Economic Cooperation and Development, Report of the Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises (1979), reported in International Bureau of Fiscal Documentation, The Tax Treatment of Transfer Pricing (1987 & Supp. 1991) (hereinafter, “Transfer Pricing”).

standard.[229] Therefore, the Committee believes that a strict periodic adjustment clause for cost sharing arrangements should be deleted in the final regulations.[230] Alternatively, if this recommendation is not adopted, the final regulations should provide that any periodic adjustment clause that is required will be sufficient if it forces cost share adjustments only in the event of “major” variations affecting the cost/benefit ratios of the participants.[231] The Committee proposes that a “major” variation be defined as a variation that causes a U.S. participant to violate the proportionate profits rule under the substantially disproportionate test.

The Committee further proposes, however, a revision of the proportionate profits rule. The proportionate profits rule inflexibly looks to “income” as the measure of an intangible’s benefit to a participant even though in many cases income will not be the best measure of such benefits.[232] The proposed

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229 The Tax Court is in accord with this view. In R.T. French Co. v. Comm’r, supra, Judge Raum decided that two related parties were not required to adjust their contract when the royalties provided for therein began to overcompensate for the intangible benefits realized.

230 The White Paper suggests that the Service may feel compelled by the legislative history to the Tax Reform Act of 1986 to incorporate in the cost sharing regulations a periodic adjustment requirement However, the Committee believes that such compulsion is unwarranted. First, the language of the 1986 amendment to section 482 applies on its face only to transfers or licenses of intangibles and not to cost sharing arrangements. Second, while the legislative history provides explicit guidance with respect to certain issues relating to cost sharing, it does not specify a periodic adjustment requirement for cost sharing arrangements (although it goes into detail on such point in the context of transfers of intangibles).

231 When referring to such adjustments in the case of transfers of intangibles, the House Report states: “Adjustments will be required when there are major variations in the annual amounts of revenue attributable to an intangible.” H. R. Rep. No. 426, 99th Cong., 1st Sess. 426 (1985). The requirement certainly should be no more stringent in the cost snaring context.

232 For example, if one participant in a cost sharing arrangement has outdated and, therefore, costly manufacturing facilities, its income may be relatively low for a reason unrelated to the benefit provided by the intangible.

regulations recognize this shortcoming in the context of initially determining whether a reasonable effort has been made to share costs in proportion to benefits. Specifically, for purposes of determining whether a cost sharing arrangement establishes a method that reflects a reasonable effort to share costs in proportion to benefits and, therefore, is a "qualified" cost sharing arrangement, the proposed regulations provide that "[under] appropriate circumstances, anticipated benefits may be measured by reference to anticipated units of production ..., anticipated sales ..., anticipated gross or net profit, or any other measure that reasonably predicts the benefits to be shared."[233] The Committee knows of no good reason to apply this logical rule to determine qualification of the cost sharing arrangement, yet to look solely to an income measure of benefits to apply the proportionate profits rule.[234] The Committee believes that taxpayers should have the opportunity to show that a measure of benefits other than income is appropriate in application of the proportionate profits rule.

Although taxpayers do have an opportunity to reference measures other than income when attempting to rebut the presumption of disqualification under the "grossly disproportionate" test, this latter test is flawed for other reasons. First, for the same reasons stated above in connection with our discussion of the periodic adjustment requirement, it is inconsistent with the arm's-length standard to require participants in a cost sharing arrangement to agree to prevent

[233] Prop. Reg. § 1.482-2(g)(2)(ii)(A).

[234] This flawed approach to the proportionate profits rule is illustrated by section 1.482- 2(g)(4)(ii)(E) (example 2) of the proposed regulations (unit sales volumes recognized as most accurate measure of benefits, yet the proportionate profits rule applied on the basis of cost/income ratios).

future disproportionate cost/benefit ratios, even though the arrangement is at arm's-length terms when entered into taking into account the facts known at that time. Therefore, it is inconsistent with the arm's-length standard to disqualify an initially reasonable cost sharing arrangement even if cost/benefit ratios become grossly disproportionate. Although violation of the "grossly disproportionate" test results in only presumptive, and not per se, disqualification (as compared to violation of the periodic adjustment rule), we think the rule is too harsh. Before disqualification, the Service should be required to establish at a minimum that (i) cost/benefit ratios are grossly disproportionate and (ii) at the time the arrangement was entered into and as a matter of subjective intent, the parties did not make a reasonable effort to allocate costs in accordance with the actual economic activities of the participants.[235] Otherwise, the remedy should be to realign the costs, or impose the buy- in/buy-out rules, properly to reflect such economic activities.

The Committee also is concerned that the only indication in the proposed regulations of what will be viewed as grossly disproportionate is in Example 5 of section 1.482-2(g)(4)(ii)(E). In that example, the U.S. participant's cost/income ratio is found to be grossly disproportionate at approximately 5-1/2 times that of the non-U.S. participants. If the rule is retained that would disqualify a cost sharing arrangement in the event of grossly disproportionate ratios, the Committee recommends that the regulations provide a safe harbor stating that ratios of less than five times the non-U.S. participants' ratio or some other specified ratio would not be viewed as grossly disproportionate. It should be borne in mind that the only effect of this safe

[235] The "actual economic activities" language is taken from the Conference Report at n-638.

harbor would be to remove in certain cases the presumption that the agreement does not reflect a reasonable effort to allocate costs in accordance with benefits. In light of the harsh consequences of failing to overcome such a presumption, a safe harbor is appropriate.

Finally, the Committee believes that to accord with the arm's length standard, the final regulations should provide that the district director may make no allocations if it is determined, under the foregoing rules, that the arrangement is a qualified cost sharing arrangement (provided, of course, that the participants actually abide by that arrangement). By definition, such an arrangement will meet the arm's-length standard and no adjustments will be appropriate.

Active Trade or Business Requirement

The Committee believes that the active trade or business requirement in the proposed regulations should be deleted from the final regulations. We can determine no theoretical underpinning for such a requirement Moreover, it adds unnecessary complexity and a significant potential for litigation over the question of what constitutes the active conduct of a trade or business.

It has been suggested that the requirement is related to the trade or business requirement under section 162. However, there is no reason why an arrangement that is, in substance, a cost sharing arrangement should be recharacterized as a transfer of an intangible merely because one or more of the participants in the arrangement might be denied a deduction for its cost sharing expenditures. Moreover, the definition of trade or business under section 367, which the proposed regulations crossreference, does not necessarily correlate with the definition of trade or business under section 162. Finally, there is no requirement under section 162 that a trade or business be "active."

The rule is particularly inequitable where there are only two participants in the cost sharing arrangement In that case, if one of the two participants is denied "eligible participant" status, the entire cost sharing arrangement ceases to be a qualified cost sharing arrangement. Thus, the rule adversely affects parties who should have their tax treatment reflect the business realities of their transaction.

If the rule is retained, it should be narrowed. Under section 162, for example, all corporations are presumed to be carrying on a trade or business. This should be adopted as the relevant standard. With respect to non-corporate taxpayers, principles similar to those of section 183 should be adopted.

Alternatively, if the rule is retained but the standard suggested in the previous paragraph is not adopted, a standard should be adopted similar to that of the recently proposed regulations under section 1362 (termination of Subchapter S election). Under that standard, passive income does not include royalties received by a corporation that incurs substantial costs with respect to the development or marketing of the property subject to the royalty.[236] This rule is an improvement over the "substantial managerial and operational activities" test of the proposed regulations.

As a corollary to the foregoing discussion, and for the reasons already stated, we believe that the intangible

[236] See generally Prop. Reg. § 1.1362-3.

development area should not be limited. Although it may be appropriate to require that an intangible development area be broad enough to encompass related intangible development, it is inappropriate to require that it be narrow enough so that the costs shared are for the development of products or services that are of potential use to each eligible participant in the active conduct of a trade or business.

Finally, if the active trade or business requirement is retained, the Committee recommends strongly against the retention of the presumption that a taxpayer does not use an intangible in the active conduct of its trade or business if there are any significant direct or indirect transfers of intangibles to uncontrolled taxpayers during or within four years after the termination of the arrangement There may be legitimate business reasons for such a transfer independent of any indication that the intangible was not, or was not intended to be, used in the active conduct of a taxpayer’s trade or business. The proposed regulations set forth an arbitrary definition of “old and cold” that is longer than most practitioners would think reasonable.

Therefore, if the active trade or business requirement is retained, the presumption should be eliminated and the active trade or business issue should be determined entirely, not just partially, on a facts and circumstances basis. The testing period should be the length of time within which an integrated plan may be inferred, for example, under step transaction principles. The recently proposed regulations under section 338 provide one of many precedents for this approach.[237]

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[237] See Prop. Reg. § 1.338-4(j).

Finally, if the presumption is retained, it should be limited to transfers of the intangibles developed pursuant to the cost sharing arrangement Moreover, a transfer of a significant portion of those intangibles, not merely any significant transfer, should be required before the presumption applies.

Definition of U.S. Participant

The Committee believes that the definition of a "U.S. participant" is unclear and potentially overbroad.[238] Under the proposed regulations, all corporations, U.S. or foreign, "whose income or earnings may be relevant for U.S. tax purposes" fall within the definition of U.S. participant.[249] Theoretically, this would include every foreign participant corporation. Such a corporation's later acquisition by a U.S. person could cause its income or earnings to be relevant to such U.S. person under section 367(b), 951 or 1248. Even a more narrow definition, such as one that includes only foreign entities whose income or earnings are relevant for U.S. tax purposes in the year under review, would be too broad as it would embrace a foreign entity with, only a single U.S. shareholder as long as the entity paid a dividend in the year under review. Therefore, the definition of U.S. participant should include only those foreign entities that, in the year under review, are subject to U.S. tax under principles similar to those of section 1338-1T(k)(2)(v) of the temporary regulations.

Definition of Costs

The preamble to the proposed regulations requests comments with respect to whether U.S. generally accepted

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238 Prop. Reg. § 1.482-2(g)(7)(iii).

249 Id.

accounting principles, tax accounting principles or other principles should be used in the definition of “cost of developing intangibles.” There are significant arguments in favor of the use of GAAP accounting principles over tax accounting principles. These include certainty, absence of confidentiality concerns and international uniformity. Therefore, the Committee recommends that, to the extent a uniform rule is believed necessary, costs should be allocated based on GAAP.

As a related matter, the White Paper indicated that going concern value of a researcher should be compensated under the buy-in provisions. The IRS § 482 Report indicates at page 4-9 that this rule has not been adopted in the proposed regulations. The Committee recommends that there should be an affirmative statement to that effect in the regulations when finalized. The Committee agrees that arm’s-length cost sharing agreements provide for the allocation of costs prospectively incurred and typically do not take into account any going concern value that might be associated with the cost sharer performing the research.

Multi-Year Offsets

The Committee believes that the proposed regulations should provide for multi-year offsets in cases where adjustments are determined for specific years yet other years not under review would have provided the taxpayer with a tax benefit had a corresponding adjustment been made. It is only equitable that a taxpayer be able to establish that it underpaid costs for a year prior to the one with respect to which the Commissioner is determining an overpayment of costs and corresponding underpayment of tax.

Timing of Allocations

The proposed regulations provide that a Service adjustment must be included in income in the year under review, even if the costs were incurred in a prior year. Interest will also be imputed if costs are deemed paid on behalf of other participants for prior years.[240] The Committee questions whether this rule is in fact an end run around the otherwise applicable statute of limitations and suggests that the final regulations require instead that adjustments be made only to the proper years and only to the extent allowed by the statute of limitations.

Discretionary Application or Cost Snaring Rules to Intangibles Transfers

The proposed regulations provide that in “unusual” circumstances, the cost sharing rules may be applied to any arrangement that in substance constitutes a cost sharing arrangement. The Committee recommends that the final regulations spell out, with greater detail than the ambiguous term “unusual”, the circumstances in which this rule be applied. Although the Committee is not urging that the specific facts that will warrant application of the rule be spelled out,[241] the general guidelines for application of the rule should be enunciated. In that regard, the Committee is mindful that the Service unsuccessfully attempted to obtain judicial approval for an overbroad application of this approach in Ciba-Geigy Corp. v. Comm’r, supra. Therefore, guidelines for application of the rule should be set forth in the final regulations.

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[240] Prop. Reg. § 1.482-2(g)(4)(iii).

[241] Such a regulation would be at odds with the stated objectives of the Treasury Department and the Service. See Treasury Department and IRS 1992 Business Plan, supra note 10 (“general principles are often better than detailed rules.”)

Currency Fluctuations

The proposed regulations do not address the issue of currency fluctuations in the context of cost sharing arrangements. Variations in currency exchange rates, however, can have a significant impact on the cost/income ratios of eligible participants in cost sharing arrangements, thereby subjecting participants to unwarranted adjustments under the rules. For example, the income of a U.S. participant in a cost sharing arrangement might decrease its income because currency inflation causes its international suppliers' goods to become more expensive. This could cause its cost/income ratio to become substantially or grossly disproportionate. In our view, such currency fluctuations should not cause disqualification of, or reallocations under, cost sharing arrangements. Therefore, the Committee recommends that the final regulations provide a mechanism for demonstrating the effect of currency fluctuations on the regulatory tests applicable to qualified cost sharing arrangements.

Interaction With Section 367(d)

Section 367(d) sets forth rules relating to the transfer of intangibles to a foreign corporation in a transaction described in section 351 or section 361. These rules treat such a transfer as a sale, with the transferor being treated as having received amounts that reasonably reflect the amounts that would have been received as annual payments contingent on productivity, use or disposition of the property.[242]

The legislative history of section 367(d) provides that section 367(d) is to have "no application to bona fide cost

[242] § 367(d)(2)(A).

sharing arrangements (under which research and development expenditures are shared by affiliates as or before they are incurred, instead of being recouped by licensing or selling the intangible after successful development)".[243] However, the legislative history to the 1986 Act states, with respect to the "commensurate with income" standard generally:

> The requirements of the bill apply when intangibles of the type presently subject to section 367(d) are transferred by a U.S. person to a related foreign entity or to a possessions corporation that elects the cost-sharing option, or are licensed or otherwise used by such entity. Thus, the standard that payments must be commensurate with the income attributable to the intangible applies in determining the amounts to be imputed under section 367(d) and in determining the appropriate section 482 allocation in other situations.

The two quoted passages are presumably reconciled by the proposed regulations under the following analysis. The proposed regulations treat qualified cost sharing arrangements as not involving transfers of intangibles except in the case of substantially or grossly disproportionate cost/income ratios and other buy-in or buy-out situations. In such a case, i.e., where a transfer is involved,[244] the general rules of the intangibles portion of the proposed regulations apply. As such, the cost sharing rules of the proposed regulations do not apply. Therefore, in situations that are covered by the cost sharing rules, since there is no transfer, section 367(d) cannot apply. In situations that the proposed regulations characterize as subject to the general transfer of intangibles rules, not to the

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[243] Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,433 (Comm. Print 1984).

[244] The legislative history reflects the view that the section 936(h) cost sharing option should not be viewed as a qualified cost sharing arrangement; thus, in this case the commensurate with income rule would apply.

cost sharing rules, sections 367(d) and 482 apply, as the case may be.

It would be helpful if the regulations contained a statement clarifying that this is the proper interpretation of the interaction between section 367(d) and the cost sharing provisions.

Partnership Issues

The preamble to the proposed regulations seeks comments on the appropriate application of the cost sharing rules in the context of partnerships that develop and exploit intangibles. In the Committee’s view, this becomes an issue only if the partnership agreement provides for a special allocation of income or of assets on liquidation or if contractual arrangements allow the partners individually to exploit the partnership’s technology.

The Committee believes that the case of a special allocation of assets should be characterized and treated in the same manner as a buy-out under the proposed regulations. In certain factual settings, the special allocation of income and contractual arrangements cases would bear the essential character of a cost sharing arrangement in which the costs are not commensurate with benefits. As such, they should be subject to the general cost sharing rules. Other partnership arrangements are either not sufficiently analogous to cost sharing arrangements or do not present any potential for the kind of manipulation of the tax rules that section 482 was designed to address. Therefore, they should not be subject to the cost sharing rules.

Another issue is whether a cost sharing arrangement per se creates a partnership among the participants. If so, foreign participants not otherwise engaged in a U.S. trade or business may be so engaged or be treated as so engaged through a U.S. permanent establishment by virtue of the partnership's activities. A partnership, as defined by sections 761 and 7701, includes any unincorporated organization through which any business, financial operation, or venture is carried on and which is not a corporation, trust, or estate.[245] Although the proposed regulations exclude "[a] joint undertaking merely to share expenses"[246] from partnership status, certain authorities involving the exploitation of jointly owned assets have found such joint ownership to constitute a partnership.[247]

On balance, we believe that a qualified cost sharing arrangement is most appropriately characterized as a joint undertaking merely to share expenses. Therefore, in light of the importance of this issue to foreign cost sharers who otherwise would not be engaged in a U.S. trade or business, we recommend that the final regulations clarify that participants in a qualified cost sharing arrangement are not partners in a partnership solely by virtue of their participation in the cost sharing arrangement and that a qualified cost sharing arrangement, without more, does not cause foreign participants to be treated as engaged in a trade or business through a U.S.

245 § 761(a) and § 7701(a)(2).

246 Reg. § 301.7701-3(a) and Reg. § 1.761-l(a).

247 See, e.g., Rev. Rul. 68-344, 1968-1 C.B. 569; Madison Gas & Electric Co. v. Commissioner, 633 F2d 512 (7th Cir. 1980) (the taking of electricity from a joint electrical production venture for re-sale by each venture in their individual capacities was considered to be the receipt of profits "in kind" from the venture and the venture was found to be a partnership).

permanent establishment[248] Any other result could severely limit the use and effectiveness of a qualified cost sharing arrangement.

International Double Taxation

Reallocation of cost sharing payments by the Service could cause double taxation of the same income by the U.S. and a foreign government Although a taxpayer may seek relief from double taxation under a treaty's mutual agreement procedure where a treaty partner is concerned, this route is time-consuming and uncertain of result

Therefore, the Committee recommends that, to the extent possible, confirmation should be obtained from our treaty partners prior to the finalization of the regulations that they are in accord with the standards set forth in the regulations for reallocation of cost sharing payments. Conceivably, this problem could also be remedied through the negotiation of treaties and amendments to existing treaties so as to include an intercompany transfer pricing provision. Given the prominence that intercompany transfer pricing issues are gaining in international business transactions, the Committee believes that it would be prudent for the United States to pursue this course.

International Norms

Background

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[248] It should be noted that a common treaty provision excludes from the definition of permanent establishment the maintenance of a fixed place of business for "preparatory or auxiliary" scientific research. See, e&, U.S.-U.K. Treaty, Article 5(3)(e); U.S.-France Treaty, Article 4(3)(e); U.S.-Germany Treaty, Article 5(4)(e); and U.S.-Italy Treaty, Article 5(3)(e).

In addition to our discussion of the specific provisions of the proposed regulations, the Committee believes that it is important to address the compatibility of the regulations with international practices of determining arm's length prices for transfers of tangible and intangible property. While we recognize that foreign governments should not control U.S. tax policy, we strongly believe that the United States should seek to conform to international arm's length standards consistent with U.S. tax policy in order to continue to play a leadership role in international tax policy, eliminate potential double taxation and assist U.S. multinationals.

The White Paper placed great emphasis on the intention of the Treasury Department to continue its adherence to the arm's length standard.[249] As stated in the White Paper,

> The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues; and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases.[250]

The proposed regulations, while modifying the definition of arm's length, seek to implement the White Paper's conclusion that "the United States should continue to adhere to the arm's length standard".[251] Thus, in announcing the proposed regulations under section 482, representatives of the Service and the Treasury Department stated that the methods for applying the

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[249] Notice 88-123,1988-2 GB. 458, at 475-477.

[250] White Paper, at 475 (footnotes omitted).

[251] Id.

commensurate with income standard contained in the proposed regulations are compatible with international standards.[252]

There follows a discussion of the transfer pricing methods utilized by our major trading partners, first with regard to transfers of tangible property and then with regard to transfers of intangible property.

General

Accepted international practice is to apply an arm's length standard that looks to whether uncontrolled parties dealing at arm's length would enter into a similar transaction on similar terms at the time the transaction was entered into.

The most commonly cited expression of the arm's length standard as understood by our trading partners is the 1979 report by the OECD on Transfer Pricing and Multinational Enterprises (the "OECD Report").[253] The OECD Report endorses the arm's length standard and explicitly rejects formulary approaches for allocating profits between related enterprises as "necessarily arbitrary."[254] It accepts, however, the possibility that "in seeking to arrive at an arm's length price in a range of transactions, some regard to the total profits of the relevant [multinational enterprise] may ... be helpful, as a check on the assessment of the arm's length price".[255]

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[252] See comments of the Associate Chief Counsel (International) and the then International Tax Counsel reported in BNA Daily Tax Report, January 27,1992, at G-8-G- 9.

[253] See supra note 229.

[254] Transfer Pricing, at OECD Report-14-15.

[255] Transfer Pricing, at OECD Report-15 (emphasis added).

Tangible Property

As discussed above, the proposed regulations prescribe the use of three primary methods in determining transfer prices for tangible property - the comparable uncontrolled price method, the resale price method, and the cost plus method. Use of these methods is consistent with international practice. Where the proposed regulations depart from international practice is in requiring that tangible property transfer prices determined using the resale price and cost plus methods be validated using the CPI.

The OECD Report

The OECD Report envisages using four possible methods for determining a transfer price for tangible personal property: the first three methods (which are similar to the three primary methods described in the proposed regulations) and any other method (the so-called "fourth methods").[256] Fourth methods are to be used when the first three methods cannot be used.[257] The OECD Report does suggest that fourth methods might also be used to verify transfer prices derived by one of the first three methods.[258]

The fourth methods discussed in the OECD Report involve analysis of profits, but they are all suggested with diffidence, and the implication is that they should not be used as primary methods, at least not when another approach is available. Nevertheless, the OECD Report states that:

> Tax authorities may find some help in a comparison of an enterprise's overall performance with that of other

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256 Transfer Pricing, at OECD Report-24.

257 Transfer Pricing, at OECD Report-31.

258 Id.

> similar enterprises in the same or similar circumstances. Levels of a profit in an industry may for example conform to a pattern and an exception to the pattern might indicate that profits were being shifted by artificial transfer prices.[259]

However, the OECD Report immediately goes on to say that: "But comparisons of this sort would need to be made with care. It does not necessarily follow that exceptional profits or losses are artificial."[260] Furthermore, the OECD Report suggests that a profit analysis might best be used to determine whether to initiate a transfer price inquiry, not to validate the results of such an inquiry. It states that:

> It may be profitable nevertheless to make comparisons of this sort [ratio of profits to sales or operating expenses] in relation to the gross profits from sales of particular products or groups of products but even so the results of the comparison could normally be regarded only as pointers to further investigation.[261]

The OECD Report takes the same view of comparisons of yield or return on capital:

> But this too is an arbitrary assumption: the profit made by a comparable independent concern would not necessarily bear any particular relationship to the return on investment in other ways. Although therefore such an approach might have some value in indicating a reasonable range of possible profit margins the concept of a "normal" return on capital invested is too imprecise to be likely to be useful in isolation.[262]

Thus, the OECD Report does not envisage use of fourth methods as a primary method when one of the other three methods can be reasonably used. It also implies that while fourth methods

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259 Id.

260 Id.

261 Id.

262 Transfer Pricing, at OECD Report-32.

based on profits may be useful in asking transfer pricing questions, they ordinarily should not be used alone in answering them.

Major U.S. Trading Partners

Transfer Pricing contains some material about the practices of other countries with regard to transfers of tangible property. This material suggests that using a profits analysis in determining prices for transfers of tangible property, at least when one of the first three methods is available, would be viewed as contrary to accepted practice.[263]

Australia. A commentator has suggested that in determining an arm’s length price, Australia tax authorities may use one of the first three methods or fourth methods.[264] However, it is the Australian tax authorities’ view that for each case, given the facts and circumstances, there is only one appropriate method.[265]

Canada. Revenue Canada has published guidance on its transfer pricing policies' in Information Circular 87-2, International Transfer Pricing and Other International Transactions (February 27, 1987), reprinted in Transfer Pricing at Canada - 65 through Canada-76. This circular states that it is “not to be construed as a formal interpretation of the law but rather an explanation of the basis on which the Department considers that the ‘arm’s length principle’ is reflected in the Act”[266]

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[263] Note, the Transfer Pricing chapter for Japan has not yet been released.

[264] Transfer Pricing, at Australia-50.

[265] Transfer Pricing, at Australia-34.

[266] Transfer Pricing, at Canada-65.

The circular sets out the first three methods, and then goes on to state that “[o]ther methods may be employed in support of one of the three aforementioned methods or in circumstances where none of these methods is appropriate.”[267] The examples which it cites for this purpose involve consideration of cost of direct materials, full cost, value as a replacement part, and value as a fraction of the value of a larger unit[268] Profits-based fourth methods are not mentioned. Indeed, while the circular states that these other methods may be employed in support of one of the first three methods, it provides that H[t]he method utilized should reflect an attempt to present the particular transaction in terms of what would have transpired in an arm’s length relationship.”[269] Accordingly, the Canadian view appears to emphasize the use of comparables with little emphasis, and no indicated requirement, for profits-based methods.

Canada has one reported case of which we are aware, in which a court appeared to use a profits analysis as part of a fourth method. *Indalex v. The Queen*, 86 Dominion Tax Cases 6039 (Canada Fed. Ct Trial Div. 1986?), *rev’d, on other grounds*, 86 Dominion Tax Cases 6053 (Canada Fed. Ct App. 1986).[270] This case involved invoicing aluminum billets through an offshore company, and the Court apparently accepted evidence from the Canadian tax authorities based on a functional analysis of the companies

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[267] Transfer Pricing, at Canada-70.

[268] Id.

[269] Id.

[270] This case is summarized in Transfer Pricing, at Canada - 26 through Canada - 29.

involved, and referred to the *Du Pont* case as an example of such an analysis.[271]

Germany. The former Fiscal Counselor in the German Embassy to the United States states that fourth methods are not to be used as a replacement for the first three methods when one of such methods is available:

> Under the German TPG[272] these [fourth methods] are not considered to be standard methods for deriving the arm's length price for an individual transaction. Rather, they are considered as additional or auxiliary tools for the examination of the international income allocation.[273]

The German TPG provides that the first three methods are standard methods.[274] As to fourth methods, the German TPG states that:

> In applying the principles mentioned thus far, the business results which the taxpayer, a related person or unrelated parties have achieved under comparable business conditions from comparable transactions with unrelated parties can be used as a basis to identify areas which warrant special examination, to verify transfer prices or to obtain supplementary criteria for the income allocation. The combined results of connected business operations and their apportionment to the individual business operations within a group of enterprises can also be used for this purpose. The income allocation can be based on the results within the meaning of the 1st and 2nd sentences alone it because of special circumstances (e.g. where merchandise or a category of merchandise is acquired or produced, processed and marketed in a substantial quantity solely within vertically structured groups of enterprises) the standard methods would not lead to

271 E. 1. Du Pont de Nemours & Co. v. U.S., supra.

272 This is the Letter of the Federal Minister of Finance of 23 February 1983 concerning principles for the examination of income allocation in the case of internationally related enterprises (IV C 5 - S1341 - 4/83) (hereinafter, "German TPG"), official translation reprinted in Transfer Pricing at Germany (Fed. Rep.)-53 through Germany (Fed. Rep.)-87 [Footnote added].

273 Transfer Pricing, at German (Fed. Rep.)-17.

274 German TPG § 2.2, in Transfer Pricing, at Germany (Fed. Rep.)-63.

> appropriate results; the same applies in the cases mentioned in [the next paragraph]….
>
> In special cases it is not possible to compare the actual circumstances with a similar situation involving unrelated parties, above all where, applying the criteria of [arm's-length dealing], business dealings of the kind in question would not have come about between unrelated parties or would only have come about with an essentially different commercial content In these cases the allocation is to be based on the appropriate apportionment of the income arising from the series of transactions overall which sound business managers would have determined.[275]

Thus, the German view appears to be that where the first three methods can be used, fourth methods may be appropriate as investigative tools or checks, but are not to be primarily used.

Italy. Italy also appears to view fourth methods as inappropriate for primary use when the first three methods are available. A circular letter from the Ministry of Finance has the following to say about fourth methods:

> The "alternative" method will prove useful:
>
> (a) subsidiarily, when (i) in the check for the correct application of the three basic methods, some uncertainties should arise; (ii) the necessity arises of singling out the differential factor between two transactions susceptible of comparison for the purpose of the application of one of the three principal methods;
> (b) alternatively, where no possibility absolutely exists of applying the three basic methods.[276]

[275] German TPG §§ 2.4.5 - 2.4.6, in Transfer Pricing, at Germany (Fed. Rep.)-65.

[276] Circular letter No. 92267, issued by the Italian Ministry of Finance on 22 September 1980; the transfer prices in the computation of taxable income of enterprises subject to foreign control (hereinafter, the "Italian Circular"), unofficial translation reprinted in Transfer Pricing, at Italy - 57 through Italy - 92, Italy - 76.

Japan.[277] Transfer Pricing provisions were first introduced in Japan as part of its 1986 tax reform and are similar to those set out in the OECD Report[278] In fact, one of the principal draftsmen explained that the OECD Report is the “bible” for Japan’s new provisions.[279] Different from the OECD Report, however, no rule of priority applies with respect to the first three methods.[280] Rather, the most reasonable method based on the circumstances is used for calculating an arm’s length price.[281] Fourth methods may be applied only in circumstances where none of the first three methods can be used.[282]

Mexico. Mexico applies the first three methods in determining arm’s length prices, with no priority between the resale price and cost plus methods.[283] With respect to fourth methods, Mexican law provides tax authorities the power to review taxpayers’ operations using any suitable method of socioeconomic research.[284] There have been no cases, however, in which such authority has been used to determine transfer prices.[285]

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277 Note, the Transfer Pricing chapter for Japan has not yet been released.

278 International Fiscal Association, Studies on International Fiscal Law, Vol. LXXVIIa, Transfer Pricing in the Absence of Comparable Market Prices 469 (1992) (hereinafter “IFA Report”).

279 Gary M. Thomas, Structure of Japanese Operations and Other Selected Japanese Tax Issues, Int’l Tax Rev. 40 (1992) (hereinafter “Thomas”).

280 IFA Report, at 473.

281 Id., at 475.

282 Id., at 477.

283 IFA Report, at 526-27.

284 Id., at 529.

285 Id.

Netherlands. One commentator has suggested that in most cases the tax authorities look to a comparable uncontrolled price to determine the validity of the transfer price of tangible property.[286] In cases where a comparable uncontrolled price cannot be established, different methods may be adopted, including comparable profits.[287]

Switzerland. One commentator has suggested that in the case of goods and services that are the exclusive property of a company, the tax authorities will look at overall profits and profit splits. This would only be done if there were no good comparables available to demonstrate the price paid by people dealing at arm's length.[288]

United Kingdom. An Inland Revenue release indicates that, in setting transfer prices, the United Kingdom generally would look to the first three methods and follow the OECD Report, but "will in practice use any method which seems likely to produce a satisfactory result."[289] One commentator has stated that Inland Revenue might use profit-based methods if nothing else appeared likely to work.[290]

Summary

While international practice appears to permit using some form of profits analysis to determine whether tangible

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[286] Transfer Pricing, at Netherlands -19.

[287] Transfer Pricing, at Netherlands-20.

[288] Pricing, at Switzerland-8 through Switzerland-10.

[289] Revenue note on the transfer pricing of multinational enterprises, reprinted in Transfer Pricing, at United Kingdom-58 through United Kingdom - 61, United Kingdom-60.

[290] Transfer Pricing, at United Kingdom-27.

property transfer prices need investigating or whether a transfer price derived by another method makes sense, it does not appear to be the general view that tangible property transfer prices must produce an “acceptable” profit to satisfy the arm’s length standard. In particular, the general view appears to be that if the first three methods[291] can be used, transfer prices so determined will not be required also to pass a profits test The White Paper correctly states that the OECD Report authorizes inquiries into profits. But even the White Paper does not attempt to argue that use of profits-based methods with respect to tangible property is compatible with international norms when the first three methods can reasonably be used.[292] Accordingly, in the case of tangible: property, it appears that using the CPI in determining transfer prices is incompatible with international norms in situations where one of the first three methods can be reasonably used.

If the first three methods cannot be reasonably used, it would appear that looking to profits is not per se objectionable, and there is no specific feature of the CPI which appears to clearly violate international norms. However, neither the OECD Report nor any of the materials available to us concerning the major U.S. trading partners’ practices suggests relying on an analysis of profits as strongly as do the proposed regulations.

Intangible Property

In the case of intangible property, the “internationally accepted” methods for determining transfer prices are not well

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[291] Comparable uncontrolled price, resale price and cost plus methods.

[292] The discussion on the compatibility of profitability-based transfer pricing with international norms, at White Paper 59-61, is explicitly about transfers of intangible property.

developed. Methods most often used appear to include an analysis of profits. This generally accords with the proposed regulations' methods for intangibles, which are profit-based in that they require CPI validation.[293] Nevertheless, it is not clear that the weight of international practice norms rely solely on an analysis of profits, although there is precedent for doing so in particular cases.

OECD Report

The OECD Report recognizes that the determination of an arm's length consideration based on similar unrelated transactions frequently will be unusable in the case of intangible property, because there will be nothing comparable on which to base an analysis.;

> In many cases, it will be difficult to find satisfactory comparable open market transactions since the owner of intangible property (and particularly the owner of a patent) is essentially the owner of a monopoly right which he may not make available to unrelated enterprises. It is considered mat it is unlikely to be possible to construct any standard rates, such as a certain percentage of sales, as even within a given sector of industry it is extremely difficult to discern any typical rate or range of rates.[294]

The report states that no one particular method is appropriate in such a situation.[295] It does suggest that a profit-based method might be appropriate, although not without difficulties, and

[293] Of course, under the proposed regulations the primary method is the matching transaction method, which does not require validation under the CPI. As discussed above, however, the matching transaction method is available only in such narrowly defined circumstances that there is little likelihood of its applicability m practice. Accordingly, the other two methods will be predominant

[294] Transfer Pricing, at OECD Report-38.

[295] Transfer Pricing, at OECD Report-39.

might be more useful to indicate the need for further investigation than as a final answer:

> It appears that one of the common approaches employed in practice is to make a pragmatic appraisal of the trend of an enterprise’s profits over a long period in comparison with those of other unrelated parties engaged in the same or similar activities and operating in the same area. There could, of course, be many reasons for an unusual profit situation and it may be possible for the taxpayers to give satisfactory explanations for particular cases. The profit comparison approach thus remains more in the nature or an indication that the consideration charged for the use of intangible property may or may not be reasonable. Recourse to a comparison of the proportionate profits of the licensor and the licensee achieved thanks to the development and the use of the intangible property would not be a promising method. It would be very difficult to isolate the respective profits of the licensor and the licensee since a number of rights may be under license at the same time for the manufacturing of different products.... In addition there is the difficulty of knowing now to apportion the overall profit between the licensor and the licensee.[296]

Thus, while using profits analysis as a tool in analyzing transfer prices for intangibles is not incompatible with the OECD view, relying solely on a profits analysis would appear to be incompatible with the OECD view.

Major U.S. Trading Partners

Transfer Pricing contains some material about practices of other countries with regard to transfers of intangible property. This material suggests that, while a profit methods is accepted, it is not necessarily used in contravention of comparables.

Australia. A commentator has suggested that the Australian tax authorities might use an allocation of overall

[296] Id.

profits, or a comparison of profits earned by similar enterprises, in a case that could not be analyzed under one of the first three methods.[297] He also states that when the Australian tax authorities are auditing a transfer price for intangible property, some of the questions are aimed at determining profits, and whether a third party would be willing to pay such a royalty to achieve such profits.[298]

Canada. Information Circular 87-2 states that in determining a transfer price for intangible property, if no good comparable exists:

> The best that can be expected is to draw comparisons with royalty rates in the same industry or a similar industry involving relatively similar products, similar market conditions, and similar licensing arrangements.
>
> The following items might be expected to have a bearing on the determination of a royalty rate: (a) prevailing rates in the industry; (b) terms of the license, including geographic limitations and exclusivity rights; (c) singularity of the invention and the period for which it is likely to remain unique, (d) technical assistance, trade marks, and “know-how” provided along with access to the patent; (e) profits anticipated by the licensee; and (f) benefits to the licensor arising from sharing information on the experience of the licensee.[299]

Thus, although there appears to be precedent in Canada for using an analysis based in whole or in part on profits, it would seem that the Canadian approach to transfer prices of intangible property would not be based exclusively on profits.

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297 Transfer Pricing, at Australia-35.

298 Transfer Pricing, at Australia-50.

299 Transfer Pricing, at Canada-74.

Germany. In respect of German practices for determining transfer prices for intangibles, it is said that the Federal Tax Office maintains a royalty file for use in determining an acceptable royalty rate.[300] If this is not helpful and the cost plus method cannot be applied, it appears that profits might be examined on the theory that no one dealing at arm's length would agree to pay a royalty which would not allow an acceptable commercial profit.[301] Indeed, as discussed above, the German TPG apparently explicitly envisages using profits-based methods if the first three methods cannot be applied. Thus, it appears that Germany often has regard to profits analysis in determining transfer prices for intangibles, and might even make a determination based entirely on profits analysis.

Italy. The Italian Circular acknowledges that, in transfers of intangibles, good comparables will rarely exist.[302] When comparables are not available, the Italian Circular appears to take an eclectic approach, looking at both the profits of the licensor and licensee, and an analysis of the nature and value of the rights transferred.[303] The Italian tax authorities have set forth certain safe harbors.[304].

Japan. As stated above, fourth methods may be used only if one of the first three methods is inapplicable. Fourth methods include combinations of the first three methods.[305] As a last resort, profit split methods may be used.[306]

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300 Transfer Pricing, at Germany (Fed. Rep.)-33.

301 Id.; German TPG § 523, in Transfer Pricing, at Germany (Fed. Rep.)-75.

302 Transfer Pricing, at Italy-82.

303 Transfer Pricing, at Italy-82 through Italy-84.

304 Transfer Pricing, at Italy-84 through Italy-85.

305 Thomas, at 41.

Mexico. Mexico is generally an importer of technology. Accordingly, its transfer pricing issues with respect to intangibles have generally involved multinational corporations seeking to recover research and development costs on such transferred technology.[307] In this regard, the Transfer of Technology Register, created to approve technology transfer agreements, limited payments for such transfers in proportion with the revenues.[308] The Registry was eliminated in 1991.[309] It is anticipated that Mexican tax authorities will base transfer price adjustments on information obtained through exchange of information agreements that are being negotiated with other countries.[310]

Recently, however, Francisco Gil Diaz, Mexico's Undersecretary of the Ministry of Finance, warned that if the proposed section 482 rules are adopted, Mexico may be forced to adopt similar transfer pricing rules to protect its revenues, "even if Mexico fundamentally disagrees with these rules."[311]

Netherlands. The information we have been able to find concerning the practices of the Netherlands suggests that in the case of licensing companies (as opposed to original licensors or

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306 Id.

307 IFA Report, at 526.

308 Id.

309 Id.

310 Id.

311 Mexico Warns of Mirror Transfer Pricing Rules if U.S. Proposed 482 Regs Are Adopted, Tax Notes Int'l, Vol. 5,502 (1992).

end users), the Netherlands tax authorities have an extensive file and they have set safe harbors for acceptable royalties.[312]

Switzerland. As stated above, one commentator has suggested that in the case of goods and services that are exclusive property of a company, presumably including most intangible property, the tax authorities will look at overall profits and profit splits. This would only be done if there were no good comparables available to demonstrate the price paid by people dealing at arm’s length.[313]

United Kingdom. As stated above, an Inland Revenue release indicates that, in setting transfer prices, the United Kingdom generally would look to the first three methods and follow the OECD Report, but “will in practice use any method which seems likely to produce a satisfactory result”[314] One commentator has stated that Inland Revenue might use profit-based methods if nothing else appeared likely to work.[315]

Summary

International practice with respect to intangible property, as in other situations where a fourth method must be used, is not completely settled. Germany and the Netherlands permit using a file of royalties; presumably they are not unique. It appears that setting transfer prices from a profits analysis is explicitly permitted in Canada and Germany, and is not

312 Transfer Pricing, at Netherlands-21 through Netherlands-22.

313 Transfer Pricing, at Switzerland-8 through Switzerland-10.

314 Revenue note on the transfer pricing of multinational enterprises, reprinted in Transfer Pricing, at United Kingdom-58 through United Kingdom-61, United Kingdom-60.

315 Transfer Pricing, at United Kingdom-27.

necessarily unacceptable elsewhere. Accordingly, the principal difference between the proposed regulations' use of the CPI in the case of intangible property and the norms of international practice would seem not to be the use of a profit analysis, but the proposed regulations' elevation of a profits analysis to the status of a preferred method. The White Paper correctly states that the international view appears to be that when there is no comparable (which is generally the case with intangibles), the methods used often look to profits analysis.[316] Nevertheless, it would seem there is no accepted international norm requiring that such methods be based solely, or even primarily, on a profits analysis.

Comments

As mentioned above, the White Paper recognizes that the OECD Report endorses methods which consider the profits of the related enterprises in making arm's length determinations.[317] The OECD Report may thus be reconciled with the BALRM or BALRM with profit split methodologies espoused by the White Paper because these methods look at the economic functions performed by the related parties and at the relative ownership of intangibles within the controlled group.[318]

The CPI method, on the other hand, looks exclusively at the profits of other taxpayers to determine the proper allocation within the controlled group.[319] The CPI is then used to judge the

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316 White Paper, at 60, 1988-2 C.B. at 476.

317 Cf. White Paper, at 476 ("Nowhere, however, does the report suggest that the profits of the related enterprises are irrelevant to this determination").

318 White Paper, at 488-491.

319 Prop. Reg. § 1.482-2(f).

results of any method of allocation that does not (in the case of intangibles) meet strict standards of comparability as a "matching transaction", or (in the case of tangibles) is not based on a comparable uncontrolled price method.[320] If the results of any such method do not fall within the CPI, the transfer price is not considered "arm's length". In effect, the CPI method uses the profit interval of a group of other taxpayers as the ultimate measure of the propriety of an allocation under section 482.

It is hard to reconcile this use of the CPI with the emphasis in the OECD Report on looking primarily (in the absence of "true" comparables) at the related enterprises and their functions and only secondarily, if at all, at third parties. The use of the CPI as the ultimate measure of an arm's length consideration appears closer to the "global" or formulary approach criticized in the OECD Report, since it essentially disregards the transaction between the related parties altogether and substitutes another transaction (based on an analysis of the profits of third parties) for it[321]

It thus seems likely that the CPI method will lead to increasing disputes with trading partners whose approach to transfer pricing is closer to the arm's length approach embodied in the OECD Report[322] The result will likely be increased appeals to competent authority procedures and, in the absence of competent authority agreement, increased double taxation.

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320 Prop. Reg. § 1.482-2(d)(4), § 1.482-2(e)(1).

321 The effect of the arm's length approach advocated by the OECD Report is "to recognize the actual transactions as the starting point for tax assessment and not, in other than exceptional cases, to substitute other transactions for them". Transfer Pricing, at OECD Report-19.

322 See, e.g., the responses of U.K., Japanese, Mexican and German representatives, cited in Highlights and Documents, March 11,1992, at 3725-3726.

It is understandable that the Treasury Department is dissatisfied with the results in transfer pricing cases which used alleged comparables in ways that disregarded the economic functions performed by the related parties.[323] However, the solution to such problem should not be unilaterally imposing a test which ultimately disregards most related party information and relies primarily upon the profits of third parties. As mentioned herein, we have grave doubts about whether the CPI approach is workable as currently proposed. Assuming, however, that it may provide more certainty in some cases, in the absence of international agreement, it will very likely lead to double taxation and possibly retaliation. As the White Paper recognized, "in the interest of avoiding extreme positions by other jurisdictions and minimizing the incidence of disputes over primary taxing jurisdictions in international transactions", the United States should adhere to the arm's length standard as it is internationally understood.[324]

In other respects, it is necessary to closely examine whether the proposed regulations are compatible with arm's length standards internationally. As mentioned above, will our trading partners accept the emphasis of the proposed regulations on a profits-based analysis and the de-emphasis of a transactional comparability? Will they accept the emphasis of the proposed regulations on actual results (rather than projections), and the required annual re-examination and validation of the arm's length nature of multiyear transfers of intangibles? Although some form

[323] See, e.g., U.S. Steel Corp. v. Commissioner, supra; Bausch & Lomb v. Commissioner, 92 T.C. at 590-594. The specific problem of volume discounts raised by those cases has been resolved by the changes made in Prop. Reg. § 1.482-2(e)(2)(ii).

[324] White Paper, at 475.

of look-back seems mandated by the legislative history of the 1986 amendment,[325] the concept of annually re-evaluating multiyear transfers generally is inconsistent with general business practices and international standards, which generally focus on the facts and circumstances existing at the time an agreement is entered into to transfer an intangible. What will their reaction be to validating a transfer price determined by the resale price or cost plus method through the CPI? So too, international norms apparently do not test the sale of tangible property under the intangible rules as the coordination rule now requires. This difference in treatment very likely will result in inconsistent positions with our trading parties.

How will our trading partners react to the general principle enunciated in the proposed regulations as to how the arm’s length standard should be applied? The Service’s unilateral application of new approaches that may cause differences in heretofore internationally accepted standards will most likely lead to international double taxation in the absence of competent authority relief. Competent authority relief may not be available if contracting states apply different standards. These important issues must be carefully considered in determining whether the proposed regulations will provide a useful, practical and internationally acceptable framework for determining arm’s length pricing. The Committee therefore urges that there be close consultation with our treaty partners with respect to the compatibility of U.S. transfer pricing rules with international norms before final regulations are issued.

Effective Dates

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[325] Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986,1016(Comm. Print 1987).

Summary of Proposed Regulations

The regulations are effective for taxable years beginning after December 31, 1992, although the commensurate with income standard with respect to the transfers of intangibles is generally effective for taxable years beginning after December 31, 1986.[326] The proposed regulations do not apply to transfers of intangibles granted to foreign persons before November 17, 1985, or before August 17,1986 for transfers or licensing to others unless the intangible property was not in existence or owned by the taxpayer on such date.[327] The proposed regulations provide that for the period prior to the proposed effective date, the commensurate with income standard of section 482 shall be applied using any reasonable method not inconsistent with the statute.[328] The Service considers a method that applies the general principles of the proposed regulations to be a reasonable method.[329]

With respect to cost sharing arrangements, a transitional rule is provided that such arrangements will be considered qualified if the arrangement was considered bona fide under the current section 482 regulations, provided that the arrangement is amended, if necessary, to conform with the new rules of the cost sharing provisions by the date that is one year after publication of the final regulations in the Federal Register.[330]

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326 57 Fed. Reg. 3601 (Jan. 30, 1992).

327 Id.

328 Id.

329 Id., at 3,571.

330 Prop. Reg. § 1.482-2(g)(8).

Comments

It is the Committee's understanding that IRS agents in the field are utilizing the proposed regulations in connection with current audits. While the Committee recognizes that taxpayers have used a number of the approaches contained in the proposed regulations in structuring their transfer pricing and the IRS also has used a number of the approaches contained in the proposed regulations in connection with reviewing the arm's length nature of transactions under audit, the Committee believes that the specific CPI approach of the proposed regulations should not be adopted by the field as the current standard for addressing whether a section 482 adjustment should be proposed, especially since the proposed regulations currently are in proposed form and are subject to comment. To the extent the Committee's understanding is correct, it is hoped that the National Office will instruct the field accordingly.

The Committee commends the Service for adopting the transitional rule for cost sharing agreements.