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Transfer Pricing: History and Application of Regulations

History

As early as 1917, the IRS was authorized to allocate income and deductions among affiliated corporations, and require them to file consolidated returns. The predecessors of current Internal Revenue Code (IRC) Section 482 date to 1921 and 1928. The provision (added as Section 45 of the *Internal Revenue Act of 1928*) authorized the IRS commissioner to make adjustments to accounts of related parties to prevent tax avoidance and to ensure the clear reflection of income. The legislative history clarified that the latter authority permitted the commissioner to determine the "true taxable income" of related parties.[1]

Since 1935, regulations have utilized the "arm's length" standard as the means to fulfill the provision. Transfer pricing regulations issued in 1968 provided further guidance on the application of the arm's length standard, including pricing methods and additional rules for certain intercompany transactions.

The United States has helped build an international consensus in favor of the arm's length standard.

In 1986, Congress added a second sentence to IRC Section 482 that required related party transfers of intangible property to yield income "commensurate with the income attributable to the intangible." In addition to a basic concern that high-profit intangibles were being transferred outside the United States tax jurisdiction without adequate consideration, the legislative history of this provision reflects dissatisfaction with the comparability analysis in some judicial decisions.

Judicial interpretation

Some judicial interpretations of Section 482 have suggested that pricing arrangements (between *unrelated* parties for items of the same apparent general category as those involved in the *related* party transfer) may be considered a "safe harbor" for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors.[2] While Congress was concerned that such decisions may unduly emphasize the concept of comparables (even in situations involving highly standardized commodities or services), it believed that such an approach is sufficiently troublesome (where transfers of intangibles are concerned) that a statutory modification to the intercompany pricing rules regarding transfers of intangibles was necessary.[3]

In 1990, Sections 6662(a), (e), and (h)(2)(A) enacted 20 percent and 40 percent accuracy-related penalties for substantial and gross valuation misstatements. In 1993, these provisions were amended to specifically focus on whether the taxpayer generates contemporaneous documentation and analysis of its transfer pricing decisions, and provides such documentation in response to a request from the IRS.

After a 1988 U.S. Treasury Department white paper — *A Study of Intercompany Pricing* — proposed regulations in 1992, and temporary regulations in 1993, the IRS issued final regulations under Section 482 in July 1994. Temporary regulations were also issued under Section 6662(e) in July 1994 and finalized in 1996.

The United States has helped build an international consensus in favor of the arm's length standard. All of our 50 current income tax treaties (except the treaty with the former Soviet Union) contain articles requiring mutual application of the arm's length principle to resolve transfer pricing disputes. The Organization of Economic Cooperation and Development (OECD) similarly adopted the arm's length principle as the foundation of its 1979 report (*Transfer Pricing and Multinational Enterprises*) and its 1995 guidelines (*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*). Since

1995, many major U.S. trading partners have amended their transfer pricing laws to incorporate the arm's length principle, and put transfer pricing documentation requirements into effect to be consistent with the OECD guidelines.

U.S. transfer pricing regulations

The central guidance for taxpayers and IRS examiners on the application of the arm's length standard is set forth in the final regulations under IRC Section 482 issued in July 1994. These regulations were developed at the same time as (and are fully consistent with), the 1995 OECD guidelines.

Transfer Pricing Provisions

Functional analysis and comparability

The arm's length standard calls for an evaluation of the functions performed, assets used, and risks assumed by commonly controlled taxpayers in their intercompany transactions. The evaluation is measured against elements of "comparable" uncontrolled transactions between uncontrolled taxpayers. The regulations elaborate on the factors for determining comparability, including the functions, contractual terms, risks, economic conditions, and nature of the property or services involved in the controlled and uncontrolled transactions. Guidance is also provided on the significant comparability considerations under particular transfer pricing methods.

The regulations recognize that comparability does not need to be exact, although the uncontrolled transaction must be, or it must be adjusted to be sufficiently similar to provide a reliable measure of an arm's length result. Generally, adjustments based on commercial practices, economic principles, or statistical analyses must be made for material differences between the controlled and uncontrolled transactions, if the reliability of the measure is improved. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result. However, the reliability of the analysis is reduced. The extent and reliability of any adjustments affects the relative reliability of the analysis under the best method rule.

Arm's length standard

Regulations under Section 482 apply an arm's length standard to transactions between taxpayers under common control. Such taxpayers are usually referred to as "related parties," even though they may or may not be related as defined in the IRC. While the arm's length character of controlled transactions is tested through comparison with comparable uncontrolled transactions, it is recognized that uncontrolled taxpayers who engage in comparable transactions under comparable circumstances do not always achieve identical results. The IRS will not allocate taxable income where results are within an arm's length range. The final regulations provide extensive guidance on the determination of what such a range might be. For example, when the comparability of prices is somewhat unreliable, the interquartile of the range of possible prices will be considered the arm's length range.

Best method rule

Under the regulations, the arm's length result of a controlled transaction must be determined under the method that provides the most reliable measure of an arm's length result. Neither the IRS nor the taxpayer is held to the former hierarchy of methods, but if another method is subsequently shown to produce a more reliable measure of an arm's length result, that method prevails.

When choosing the best method, the two primary factors to take into account are the degree of comparability between the controlled and uncontrolled transactions, and the quality of the data and assumptions used in the analysis. If the best method rule does not clearly indicate which method should be chosen, consider whether any of the competing methods produce results that are consistent with results obtained using another method.

Transfer of tangible property using five specific methods

Subject to the best method rule, the regulations permit the arm's length results of controlled transactions involving the transfer of tangible property, (e.g., the intercompany sale of goods), to be determined under any of five specified methods or under an unspecified method.

The five specified methods are the comparable uncontrolled price, resale price, cost plus, comparable profits, and profit split.

Comparable uncontrolled price method (CUP)

Under the CUP method, the transfer price in a controlled transfer of tangible property is evaluated by referring to the price in a comparable uncontrolled transaction. Such transactions may be between two third parties (external CUP) or between one of the related parties and a third party ("internal CUP). The regulations give guidance on comparability considerations and adjustments (e.g., for volume, level of the market, geographic market, or trademark). In particular, similarity of products generally will have the greatest effect on comparability under this method. The results derived from the CUP method are generally the most direct and reliable measure of an arm's length result if there are no differences between the controlled and uncontrolled transactions, or if there are only minor differences with definite and obvious effects on price for which adjustments are made. If an exact comparable transaction is not available, the CUP method may still be used based on an inexact comparable transaction, but the reliability of the analysis as a measure of arm's length results will be reduced.

The results derived from the CUP method are generally the most direct and reliable measure of an arm's length result if there are no differences between the controlled and uncontrolled transactions.

Resale price method (RP)

The resale price method evaluates the gross profit margin earned in the controlled transaction by referring to the gross profit margin realized in comparable uncontrolled transactions. The regulations provide guidance on comparability considerations and adjustments, including the need for consistency between the controlled and uncontrolled transactions in cost accounting practices that materially affect the gross profit margin. The resale price method focuses on the value of the reselling functions, so while similarity in functions, risks, and contractual terms is significant, comparability under this method is less dependent on similarity in the physical products. The resale price method is not ordinarily used where the controlled taxpayer uses its intangible property (e.g., trademarks) to add substantial value to the goods resold.

Cost plus method (CP)
The cost plus method is similar to the RP method, except instead of focusing on the resale price (gross profit markup), the CP focuses on the value of the production functions. So while similarity in functions, risks, and contractual terms is significant, comparability under this method is less dependent on similarity in the physical products being produced.

Comparable profits method (CPM)
The comparable profits method evaluates the operating profit earned in the controlled transactions (relevant business activity) by referring to the operating profit that would have been earned if performance in the relevant business activity were equal to the profit level indicator in comparable uncontrolled transactions. The relevant business activity encompasses the most narrowly identifiable business activity for which data incorporating the results of the controlled transactions is available. In this analysis, the tested party (i.e., the controlled taxpayer whose relevant business activity is being evaluated) generally is the least complex of the affiliated taxpayers and does not utilize valuable intangible property or unique assets in the controlled transactions to a degree that is distinguishable from the uncontrolled transactions.

The regulations provide for a variety of profit level indicators, such as the ratios of operating profit to operating assets, operating profit to sales, and gross profit to operating expenses. Generally, the analysis must be made over at least a three-year period that includes the taxable year under review and the preceding two taxable years, since use of data from multiple years may increase reliability by avoiding the distorting effects on operating profit of business cycles or life cycles of the product or intangible being examined.

The comparable profit method focuses on the return on investment of resources and assumption of risk in the relevant business activity, so similarity in resources employed and risks assumed is significant.

In addition, the regulations provide guidance on comparability considerations and adjustments, including the need for consistency between the controlled and uncontrolled transactions in cost accounting practices that materially affect operating profit and the need to allocate costs, income, and assets between the relevant business activity and other activities of the tested party and the uncontrolled comparable.

The comparable profit method focuses on the return on investment of resources and assumption of risk in the relevant business activity, so similarity in resources employed and risks assumed is significant. Comparability under this method is less dependent on similarity in physical products and generally tolerates a greater degree of functional differences than other methods, since taxpayers performing different functions may have very different gross profit margins, but earn similar levels of operating profit. On the other hand, comparability under this method may be more sensitive to other factors (e.g., management efficiency that may affect the reliability of the analysis).

Profit split method (PSM)
The profit split method is applied using one of two alternative approaches. Under the comparable profit split, the combined operating profit or loss earned by the controlled taxpayers in the controlled transactions (relevant business activity) is allocated between them by referring to the allocation between uncontrolled taxpayers of the combined operating profit or loss in comparable uncontrolled transactions. Under the residual profit split, a two-step process is used to allocate the combined operating profit or loss from the relevant business activity between the controlled taxpayers.

The first step allocates operating income to each party to provide a market return to its routine contributions of tangible property, services, and intangibles to the relevant business activity. Such market returns may be determined under any of the other provisions of the regulations (e.g., the comparable profits method). The second step allocates the residual profit or loss between the parties based on the relative value of their contributions of unique intangible property to the relevant business activity, as measured by external or internal gauges. The regulations provide guidance on comparability considerations and adjustments, including the need for consistency between the controlled and uncontrolled transactions in cost accounting practices that materially affect operating profit, and on the need to allocate costs, income, and assets between the relevant business activity and other activities of the parties.

The reliability of the analysis under the comparable profit split and the first step of the residual profit split depends on similar considerations as applied to the external market benchmarks used under other provisions of the regulations. To the extent the allocation of profit or loss in the second step of the residual profit split is *not* based on external market benchmarks, the reliability of the analysis is decreased. The reliability of both profit split approaches may be enhanced by their two-sided evaluation of the contributions of both parties to the controlled transactions, as distinguished from the one-sided analysis under other methods, provided data and assumptions with respect to both parties are similarly reliable.

Unspecified methods
The regulations also permit the use of unspecified methods, subject to the best method rule. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the realistic commercial or business alternatives prior to entering into a transaction. Thus, an unspecified method should provide information on the prices or returns available under realistic alternatives to the controlled transaction.

Transfer of intangible property
Subject to the best method rule, the regulations permit the arm's length results of controlled transactions involving the transfer of intangible property (e.g., the intercompany license of patents) to be determined under any of these three specified methods: the comparable uncontrolled transaction (CUT) method, the comparable profits method, or the profit split method (or under an unspecified method) .

Comparable uncontrolled transaction method (CUT)
Under the CUT method, the transfer price in a controlled transfer of intangible property is evaluated by the price in a comparable uncontrolled transaction. The regulations provide guidance on the comparability considerations and adjustments (e.g., exclusive or nonexclusive rights, stage of development of the intangible, and duration of license). In particular, this method requires that the controlled and uncontrolled transactions involve either the same or comparable intangible property.

To be comparable for this purpose, both intangibles must be used in connection with similar products or processes within the same general industry or market and have similar profit potential. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. The results derived from the CUT method generally will be the most direct and reliable measure of an arm's length result if there are only minor differences between the controlled and uncontrolled transactions, with definite and reasonably ascertainable effects on price for which appropriate adjustments are made. If such an exact comparable is not available, the CUT method may still be used based on an inexact comparable, but the reliability of the analysis as a measure of arm's length results will be reduced.

Subject to the best method rule, the regulations permit the arm's length results of controlled transactions involving the transfer of intangible property.

The regulations implement the "commensurate with income principle" of the second sentence of IRC Section 482, with respect to transfer of intangible property. The regulations authorize the IRS to adjust the consideration charged for the transfer in subsequent years, even if the charges in earlier years are determined to be arm's length (periodic adjustments). There are exceptions to the periodic adjustments rule. Among the exceptions are cases in which the consideration charged for the transfer is based on an exact comparable or, where an inexact comparable is used; the actual results do not diverge (except due to extraordinary events beyond the taxpayer's control that could not reasonably have been anticipated) from projected results by more than 20 percent (among other conditions).

For intangible property, the profit split, comparable profits and unspecified methods, follow the guidance as discussed in the tangible property section above.

Controlled services
Generally, a controlled services transaction includes any activity by one member of a group of controlled taxpayers (the renderer) that results in a benefit to one or more other members of the controlled group (the recipient(s)). The regulations provide guidance on what constitutes an activity that results in a benefit, and specifies activities that are not beneficial.

These include: 1) activities with an indirect or remote benefit; 2) duplicative activities; 3) shareholder activities; and 4) passive association. The regulations also provide for the disaggregation of transactions for purposes of determining the arm's length consideration, if that analysis is the most reliable means of determining the arm's length consideration for the controlled services transaction.

Definition of total services costs — In the context of controlled services, the regulations define total services costs as "all costs of rendering those services for which total services costs are being determined." Total services costs include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated to, the services. In general, costs for this purpose should include provisions for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. According to the regulations, reference to generally accepted accounting principles or federal income tax accounting rules may provide a useful starting point, but will not necessarily be conclusive regarding inclusion of costs in total services costs. Total services costs do not include interest expense, foreign income taxes (as defined in Section 1.901 -2(a)), or domestic income taxes.

Cost allocation and apportionment — The regulations provide guidance for the allocation and apportionment of costs where: 1) the renderer's activity that results in a benefit for one recipient in a controlled services transaction also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this section in the controlled services transaction is determined under a method that makes reference to costs, or 2) it is appropriate to allocate and apportion any class of costs (for example, overhead costs) in order to determine the total services costs of rendering the services. In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate.

Any reasonable method may be used to allocate and apportion costs. In establishing the appropriate method, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by applying reasonable departmental overhead rates. Allocations and apportionments of costs must be made on the basis of the full cost rather than incremental cost.

The practices used by the taxpayer to apportion costs in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint ventures, clients, customers, potential investors, or other parties or agencies in interest will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the IRS commissioner. In determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members in apportioning costs among themselves will also be considered if the relationships with the foreign members are comparable to the relationships among the domestic members of the controlled group.

Methods for determining the arm's length amount

The arm's length amount charged in a controlled services transaction must be determined under one of the following methods:

- The services cost method (SCM)
- The comparable uncontrolled services price method (CUSP)
- The gross services margin method (GSM)
- The cost of services plus method (CSP)
- The comparable profits method (CPM)
- The profit split method (PSM)
- Unspecified methods

Each method must be applied in accordance with the provisions of Section 482-1, including the best method rule of Section 482-1(c), the comparability analysis of Section 482-1(d), and the arm's length range of Section 1.482-1(e), except as modified in the controlled services section.

A summary of the methods to determine the arm's length amount charged in a controlled services transaction follows:

Services cost method (SCM)

The SCM evaluates whether the amount charged for covered services is arms length by reference to the total services costs with no markup. If covered services meet the conditions for this method, then the SCM will be considered the best method for purposes of the best method rule under Section 482-1(c). In order to qualify for the services cost method, the services cannot contribute significantly to fundamental risks of business success or failure. Services are not covered services unless the taxpayer reasonably concludes in its business judgment that the covered services do not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer, the recipient, or both. This determination is based on facts and circumstances.

Use of the services cost method requires adequate books and records. Permanent books of account and records are maintained for as long as the costs, with respect to the covered services, are incurred by the renderer. The books and records must include a statement of the taxpayer's intention to apply the services cost method to evaluate the arm's length charge, and must be adequate to permit IRS commissioner verification of the total services costs incurred by the renderer. This includes a description of the services in question, identification of the renderer and the recipient of such services, and sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services in question (Refer to the cost allocation and apportionment section for more details).

Several service categories are excluded, including:

- Manufacturing
- Production
- Extraction, exploration, or processing of natural rources
- Construction
- Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement
- Research, development, or experimentation
- Engineering or scientific
- Financial transactions, including guarantees
- Insurance or reinsurance

Covered services under the services cost method consist of a controlled transaction (or a group of controlled service transactions) that meet the definition of specified covered services or low margin covered services.

Specified covered services are controlled services transactions that the IRS commissioner specifies by revenue procedure. Services will be included in such revenue procedure based upon the commissioner's determination that the specified covered services are support services common among taxpayers across industry sectors and generally do not involve a significant median comparable markup on total services costs (see discussion below). The IRS commissioner may add to, subtract from, or otherwise revise the specified covered services described in the revenue procedure by subsequent revenue procedure. Such amendments will ordinarily be prospective in their effect.

Low margin covered services are controlled services transactions for which the median comparable markup on total services costs is less than or equal to 7 percent. The median comparable markup on total services costs means the excess of the arm's length price of the controlled services transaction determined under the general Section 482 regulations without regard to the services cost method. It uses the interquartile range described in Section 482-1(e)(2)(iii)(C) and as necessary, adjusts to the median of such interquartile range, over total services costs, expressed as a percentage of total services costs.

The regulations provide guidance for covered services that are the subject of a shared services arrangement. For these covered services, the arm's length charge to each participant will be the portion of the total costs of the services otherwise determined under the services cost method that is properly allocated to such participant pursuant to the arrangement. The shared services arrangement must meet certain requirements specified in the regulations. The regulations provide guidance on the allocation of costs and required documentation. The regulations also define a "participant" and provide special rules for aggregation of covered services and coordination with cost sharing arrangements.

Comparable uncontrolled services price method (CUSP)
The CUSP method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the amount charged in a comparable uncontrolled services transaction. The CUSP method is ordinarily used where the controlled services either are identical to or have a high degree of similarity to the services in the uncontrolled transaction.

The regulations provide guidance on the comparability considerations and adjustments (e.g., for quality of services, contractual terms, and intangibles used in rendering services). In particular, similarity of the services rendered, and of the intangibles (if any) used in performing the services, generally will have the greatest effects on comparability under this method.

The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions, but only if:

1. The data are widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions.
2. The data are used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions.

3. The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

Gross services margin method (GSM)
The GSM method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs a portion of the services provided.

The gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer in the controlled services transaction in connection with the relevant uncontrolled transaction is arm's length by determining the appropriate gross profit of the controlled taxpayer.

The relevant uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer for which the controlled taxpayer performs agent services or an intermediary function.

The applicable uncontrolled price is the price paid or received by the uncontrolled taxpayer in the relevant uncontrolled transaction.

The appropriate gross services profit is computed by multiplying the applicable uncontrolled price by the gross services profit margin in comparable uncontrolled transactions. The determination of the appropriate gross services profit will take into account any functions performed by other members of the controlled group, as well as any other relevant factors described in Section 1.482-1 (d)(3). The comparable gross services profit margin may be determined by reference to the commission in an uncontrolled transaction, where that commission is stated as a percentage of the price charged in the uncontrolled transaction.

The regulations provide guidance on the comparability considerations and adjustments (e.g. for contractual terms, intangibles used in providing the service, and risks borne). Comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangibles (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences.

If a controlled taxpayer that performs an agent service or intermediary function is comparable to a distributor that takes title to goods and resells them, the gross profit margin earned by such distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit margin affects the reliability of the results under this method.

Cost of services plus method (CSP)
The CSP evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit markup realized in comparable uncontrolled transactions. This method is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties. It is ordinarily not used in cases where the controlled services transaction involves a contingent payment arrangement.

The CSP measures an arm's length price by adding the appropriate gross services profit to the controlled taxpayer's comparable transactional costs.

The appropriate gross services profit is computed by multiplying the controlled taxpayer's comparable transactional costs by the gross services profit markup, expressed as a percentage of the comparable transactional costs earned in comparable uncontrolled transactions.

The regulations provide guidance on what is included in the comparable transactional costs (i.e., employee compensation, materials and supplies, etc.).

The regulations provide guidance on the comparability considerations and adjustments (e.g., the complexity of the services, duration or quantitative measure of services, contractual terms, etc.). Comparability under this method is particularly dependent on the similarity of services or functions performed, risks borne, intangibles (if any) used in providing the services or functions, and contractual terms or adjustments, to account for the effects of any such differences. Comparability under this method is less dependent on close similarity between the services provided than under the comparable uncontrolled services price method.

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit markup affects the reliability of the results under this method.

Comparable profits method (CPM)
The CPM evaluates whether the amount charged in a controlled transaction is arm's length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The rules in Section 482-5 relating to the comparable profits method apply to controlled services transactions, except as modified in paragraph (f).

This method applies where the relevant business activity of the tested party, as determined under Section 482-5(b)(2), is the rendering of services in a controlled services transaction. Where the tested party determined under Section 1.482-5(b)(2) is instead the recipient of the controlled services, the rules under this method are not applicable to determine the arm's length result.

In addition to the profit level indicators provided in Section 482-5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs.

Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method. If there are material differences, the regulations provide guidance for adjustments.

Profit split method (PSM)
The PSM evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The relative value of each controlled taxpayer's contribution is determined in a manner that reflects the functions performed, risks assumed, and resources employed by such controlled taxpayer in the relevant business activity. For application of the profit split method (both the comparable profit split and the residual profit split), see prior discussion contained in the transfer of tangible property section of this report. The residual profit split method is ordinarily used in controlled services transactions involving a combination of non-routine contributions by multiple controlled taxpayers.

Unspecified methods
The regulations also permit the use of unspecified methods, subject to the best method rule. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it.

Potential tax penalties under IRC Section 6662

Discussion of regulations
In general, Section 6662 provides for 20 percent and 40 percent penalties in case of valuation misstatements. It also provides that any portion of the increase in taxable income which is attributable to any predetermination of a price will not be subject to penalties if:

- It is established that the taxpayer determined such price in accordance with a specified pricing method set forth in Section 482 regulations
- The taxpayer's use of such method was reasonable

- The taxpayer has contemporaneous documentation which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable
- The taxpayer provides such documentation to the IRS within 30 days of a request for such documentation

If the selected method is not a specific pricing method, the taxpayer must establish that none of the specific pricing methods was likely to result in a price that would clearly reflect income; and therefore, the taxpayer used an unspecified method that was likely to result in a price that would clearly reflect income.

The final transfer pricing penalty regulations emphasize that a 10-point document test must be met in order to avoid penalties in the event of a transfer pricing adjustment. The final regulations are divided into two document categories, principal and background. There are 10 types of principal documents; these are the ones that must exist when the U.S. tax return is filed.

Resources

Author

- Ed Morris is a valuation managing director specializing in transfer pricing.

Footnotes

[1] H.R. Rep. No. 2, 70th Congress, 1st Session, 16-17 (1928).

[2] United States Steel Corporation v. Commissioner, 617 F.2d 942, 2d Cir. 1980.

[3] Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Congress, 1st Session, 1014-15 (1987).