

Briefing Notes in Economics

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Indexed with the Journal of Economic Literature – ISSN 0968-7017

Issue No. 87, September/October 2012

Transfer Pricing Under IRC Section 482*

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First version received on 3rd April 2011

I review the methods of transfer pricing adjustment used by the IRS for transfers of tangible and intangible property between related parties. An example, using the comparable profits methodology, is also shown. JEL: F23, H26.

1. Introduction and Background

The purpose of Section 482 of the Internal Revenue Code is to ensure that taxpayers properly reflect income attributable to related party transactions. In order to achieve that objective, Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. In cases where a controlled taxpayer has not reported its true taxable income, Section 482 authorizes the Internal Revenue Service (IRS) to make allocations between or among entities in the controlled group in which the taxpayer is a member. These allocations may involve income, deductions, credits, allowances, basis, or any other item or element affecting taxable income. The appropriate allocation may take the form of an increase or decrease in any relevant amount.

The income tax regulations relating to Section 482 provide a set of rules and guidelines for determining the true taxable income of a controlled taxpayer. First, the regulations establish the standard by which the true taxable income of a controlled taxpayer is to be measured. Under Sec. 1.482-1(b)(1), the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer ("arm's length standard"). A controlled transaction is considered to be in compliance with the arm's length standard if the results of that transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

Second, the Section 482 regulations provide that a controlled taxpayer's true taxable income shall be

determined on the basis of a particular set of methods (“arm’s length methods”). These methods are to be used to evaluate whether transactions between or among members of a controlled group satisfy the arm’s length standard, and if they do not, to determine the arm’s length result. The applicable Section 482 regulations prescribe several methods for determining the arm’s length price in cases involving the sale of tangible and intangible property: the comparable uncontrolled price method (CUP), the resale price method (RPM), the cost plus method (C&M), the comparable profits method (CPM), the profit split method, the comparable uncontrolled transaction method (CUT), and unspecified methods.

Finally, the Section 482 regulations provide a set of rules and guidelines for applying the various arm’s length methods. Under the current regulations, the arm’s length methods must be applied in accordance with the provisions of the “best method rule” of Sec. 1.482-1(c), the comparability and reliability guidelines of Sec. 1.482-1(d), and the rules for determining the arm’s length range of Sec. 1.482-1(e).

2. Methods

Under the regulations for the comparable uncontrolled price method, the determination of whether the amount charged in a controlled sale is arm’s length is determined by reference to the amount charged in a “comparable uncontrolled sale.” The applicable regulations define a comparable uncontrolled sale, under Sec. 1.482-2(e)(2)(ii), as one in which the physical property and circumstances involved in the uncontrolled sale are identical to those in the controlled sale—or 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 the uncontrolled sales. The applicable regulations provide, under Sec. 1.482-2(e)(1)(ii), that the CUP method must be used in all cases where a valid comparable uncontrolled sale is available.

Under the regulations for the resale price method, the determination of whether the amount charged in a controlled transaction is arm’s length is made by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method is designed to measure the value of functions performed, and it is ordinarily used in cases involving the purchase and resale of property in which the reseller has not added substantial value to the goods by physically altering the goods before resale. The applicable regulations provide, under Sec. 1.482-2(e)(3)(ii), that the resale price method must be used to compute an arm’s length price in cases where all of the following “circumstances” exist:

- (1) There are no applicable “comparable uncontrolled sales” as defined under the regulations.
- (2) An “applicable resale price,” as defined under the regulations, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.
- (3) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. (For this purpose, packaging, labeling, or minor assembly of property does not constitute physical alteration.)
- (4) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property.

The Section 482 regulations establish rules and guidelines for applying the resale price method. Under the applicable regulations, the arm’s length price of a controlled sale is equal to the “applicable resale price,” reduced by an “appropriate markup.” The regulations define the applicable resale price as the price at which it

is anticipated that property purchased in a controlled sale will be resold by the buyer in an uncontrolled sale. According to the regulations, the applicable resale price will generally be equal to either the price at which current re-sales of the same property are being made or the resale price of the particular item of property involved. Where the property purchased in the controlled sale is resold in another controlled sale, the applicable resale price is considered to be the price at which such property is finally resold in an uncontrolled sale (Sec. 1.482-2(e)(3)(iv) and (v)).

The regulations state that the “appropriate markup” shall be determined by multiplying the “applicable resale price” by an “appropriate markup percentage.” The regulations define the appropriate markup percentage as the percentage of gross profit (expressed as a percentage of sales) earned by the buyer/reseller or another party on the resale of property which is both purchased and resold in an uncontrolled transaction that is most similar to the resale of property involved in the controlled sale (Sec. 1.482-2(e)(3)(vi)). Under the applicable regulations, the most important “characteristics” to be considered in determining the similarity of re-sales are the following:

- (1) the type of property involved in the sales;
- (2) the functions performed by the reseller with respect to the property;
- (3) the effect on price of any intangible property utilized by the reseller in connection with the property resold; and
- (4) the geographic market in which the functions are performed by the reseller.

With regard to the similarity of re-sales, the regulations state that “the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and re-sales on the one hand and the controlled purchases and re-sales on the other hand. Thus, close physical similarity of the property involved in the sales is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.” (Sec. 1.482-2(e)(3)(vi))

The regulations state in addition that “whenever possible, markup percentages should be derived from uncontrolled purchases and re-sales of the buyer (reseller) involved in the controlled sale, because similar characteristics are more likely to be found among different re-sales of property made by the same reseller than among sales made by other resellers.” However, the regulations also provide that in the absence re-sales by the same buyer (reseller) which meet the standards of similarity established under the regulations, evidence of an appropriate markup percentage may be derived from re-sales by other resellers selling in the same or a similar market in which the controlled buyer (reseller) is selling, providing such resellers perform similar functions. In addition, the regulations provide that in the absence of data on markup percentages of particular sales or groups of sales, the prevailing markup percentage in the particular industry involved may be appropriate (Sec. 1.482-2(e)(vii)).

Finally, the regulations state that in determining an arm’s length price, adjustments must be made to reflect “any material differences” between the uncontrolled purchases and re-sales used as the basis for the calculation of the appropriate markup percentage and the re-sales of property involved in the controlled sale. The

regulations define “material differences” as functions or circumstances which have a definite and reasonably ascertainable effect on price (Sec. 1.482-2(e)(3)(ix)).

Under the regulations for the cost plus method, the determination of whether the amount charged in a controlled transaction is arm’s length is made by reference to the gross profit markup realized in comparable uncontrolled transactions. The cost plus method is ordinarily used in cases involving the manufacture, assembly, or production of goods that are sold to related parties. The applicable regulations provide that in cases where the standards for the application of both the resale price and CUP methods are not met, either the resale price or the cost plus method may be used, depending upon which method is more feasible and more likely to result in an arm’s length price.

The comparable profits methodology, as described in Sec. 1.482-5, may be used for both tangible and intangible property transfers. The CPM relies on the general principle that over time, similarly situated taxpayers will tend to earn similar returns. The CPM determines the arm’s length range for a related party transaction by reference to measures of operating profit (profit level indicators) obtained from unrelated party transactions that engage in similar activities with unrelated parties under similar circumstances.

In determining an arm’s length result under the CPM, the taxpayer’s average operating profit for the year under review and the preceding two taxable years ordinarily will be compared to the average result of the unrelated parties for the same period. If the taxpayer’s average operating profit for this period falls outside of the range of arm’s length results determined according to Sec. 1.482-1(e)(2), an adjustment to the taxpayer’s income may be made. In most cases, the adjustment will be made to the median of the unrelated comparable companies’ results for the year in question.

The profit split method is described in Sec. 1-482-6. As in the case of the CPM, the profit split method may be used for related party transactions involving tangible or intangible property. The basic approach of the profit split method is to estimate an arm’s length return by comparing the relative economic contributions that the related and unrelated parties make to the success of a business venture and dividing the returns from that venture between them on the basis of the relative value of these contributions. Two profit split methods are provided: the comparable profit split and the residual profit split.

The comparable profit split is described in Sec. 1.482-6(c)(2). A comparable profit split is derived from the combined profit of unrelated parties whose transactions are similar to those of the related parties in the same business activity. Under this method, each unrelated party’s percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the business activity.

Section 1.482-6(c)(3) describes the residual profit split. The residual profit split determines an arm’s length result in a two step process. First, using other methods such as the CPM, market returns for routine functions are estimated and allocated to the parties that performed them. The remaining residual amount is then allocated between the parties on the assumption that that this residual is attributable to intangible property contributed to the activity by the related parties. Based on this assumption, the residual is then divided based on the estimate of the relative value of the parties’ contributions of such property.

The comparable uncontrolled transaction method is described in Section 1.482-4(c). The CUT method determines an arm’s length royalty for an intangible by reference to unrelated transfers of comparable intangible property under similar circumstances. An important consideration under this method is the profit

potential of the intangibles in the related party and unrelated party transactions. Section 1.482-4(c)(2)(iii)(B)(1) requires that two conditions be satisfied in order for the intangible property involved in the transactions to be comparable. First, the intangibles must be used in connection with similar products or processes in the same general industry or market; and, second, the intangibles must have similar profit potential. For the latter condition to be satisfied, the regulations state that profit potential is most reliably measured based upon projections of the net present value of the benefits to be realized through the use of the intangible.

Section 1.7482-3(e) specifies that in addition to the methods provided for in the regulations, unspecified methods may also be used for both tangible and intangible property transfers. These methods should reflect the arm's length standard and should provide data on prices and profits that the related party could have realized by choosing a realistic alternative to the controlled transaction.

3. An Example

The comparable profits methodology is employed with the taxpayer compared with comparable companies. The operating margin, the ratio of operating income to net sales, was used as the profit level indicator (PLI). The profit data for the comparables are shown in Table 1. As can be seen from Table 1, for the years 2002-2004, the interquartile range for the ratio of the average operating income to net sales is between 4.4 and 12.1 percent, with a median of 10.6 percent. The interquartile range is the range from the 25th to the 75th percentile of the results derived from the unrelated comparable companies (see Sec. 1.482-1(e)(2)(iii)(C)). If the taxpayer's average operating margin for the same period in the U.S. falls below 4.4 percent, it would fall below the interquartile ranges for the comparables. Consequently, an adjustment to the taxpayer's operating income would be warranted in this case. The adjustment would normally be made to bring the taxpayer's operating up to the median operating income of the comparables, i.e., 10.6 percent.

4. Summary and Conclusions

This paper has reviewed the methods of transfer pricing adjustment used by the IRS for transfers of tangible and intangible property between related parties. An example, using the comparable profits methodology, was also shown. This methodology is one of the most commonly used by both the IRS and taxpayers alike, due to its' simplicity and ease of data collection.

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Disclosure's SEC Database.

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Table 1: Comparables (000)

	2004	2003	2002	Average	Oper. Margin Avg. 2002-04
<i>Company A</i>					
Net Sales	\$413,016	\$55,554	\$373,702	\$280,757	
COGS	\$352,761	\$48,253	\$290,652	\$230,555	
Gross Profit	\$60,255	\$7,301	\$83,050	\$50,202	
R&D	\$10,179	NA	\$8,896	\$9,538	
SG&A	\$63,801	\$19,608	\$53,815	\$45,741	
DEP.	NA	NA	NA	NA	
Oper. Inc.	-\$13,725	-\$12,307	\$20,339	-\$1,898	
Oper. Margin					-0.7%
<i>Company B</i>					
Net Sales	\$184,418	\$161,213	\$159,111	\$168,247	
COGS	\$149,436	\$129,073	\$129,693	\$136,067	
Gross Profit	\$34,982	\$32,140	\$29,418	\$32,180	
R&D	NA	NA	NA	NA	
SG&A	\$16,742	\$15,785	\$16,462	\$16,330	
DEP.	\$275	\$291	\$1,037	\$534	
Oper. Inc.	\$18,240	\$16,355	\$12,956	\$15,850	
Oper. Margin					9.4%
<i>Company C</i>					
Net Sales	\$173,267	\$148,845	\$155,075	\$159,062	
COGS	\$145,807	\$112,596	\$117,193	\$125,199	
Gross Profit	\$27,460	\$36,249	\$37,882	\$33,864	
R&D	NA	NA	NA	NA	
SG&A	\$15,214	\$14,909	\$15,071	\$15,065	
DEP.	NA	NA	NA	NA	
Oper. Inc.	\$12,246	\$21,340	\$22,811	\$18,799	
Oper. Margin					11.8%
<i>Company D</i>					
Net Sales	\$36,700,000	\$31,034,000	\$30,723,000	\$32,819,000	
COGS	\$27,221,000	\$22,508,000	\$22,508,000	\$24,079,000	
Gross Profit	\$9,479,000	\$8,526,000	\$8,215,000	\$8,740,000	
R&D	\$1,256,000	\$1,027,000	\$1,027,000	\$1,103,333	
SG&A	\$3,753,000	\$3,654,000	\$3,343,000	\$3,583,333	
DEP.	NA	NA	NA	NA	
Oper. Inc.	\$4,470,000	\$3,845,000	\$3,845,000	\$4,053,333	
Oper. Margin					12.4%

Source: Disclosure's SEC Database

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