

**GENERAL DISTRIBUTION**

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**INTERCOMPANY TRANSFER PRICING REGULATIONS UNDER US SECTION 482 TEMPORARY  
AND PROPOSED REGULATIONS**

**THE COMMITTEE ON FISCAL AFFAIRS**

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

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**COMPLETE DOCUMENT AVAILABLE ON OLIS IN ITS ORIGINAL FORMAT**



## CHAPTER 1

### INTRODUCTION

1.1 The problems currently being encountered in the transfer pricing area by the United States are not new and are similar to those encountered by other Member countries of the OECD. The Task Force wishes to emphasise again that these difficulties, which are inherently global in nature, cannot be resolved unilaterally. A multilateral approach is required which builds upon widely accepted principles of international taxation. The recent discussions in the United States regarding the proposed Regulations provide a new approach to the determination of transfer prices that will be considered in the revision of the OECD's guidelines set out in the 1979 report entitled "Taxation and Multinational Enterprises" (hereinafter referred to as the OECD 1979 Report).

1.2 The purpose of the present report, which has been prepared by a special Task Force established by the Committee on Fiscal Affairs of the OECD, is to provide the United States Administration with the collective views of other OECD Member countries on the new Regulations under Section 482 of the United States Internal Revenue Code (hereinafter referred to as the revised Regulations). The report identifies issues set out in the OECD's report "Tax Aspects of Transfer Pricing within Multinational Enterprises: The United States Proposed Regulations" (hereinafter referred to as the Task Force Report) that continue to be of concern in the revised Regulations issued in January 1993. It also identifies a number of new problems that arise with the Regulations in their present format. The United States was not a member of this Task Force but participated as an observer.

1.3 Once again, the Member countries of the OECD stress that they are prepared to work further with the United States, both bilaterally and in such international fora as the OECD, to address the problems to which the revised Regulations are directed.

1.4 The structure of this report is as follows. Chapter 1 (the present chapter) provides the background to the report. Chapter 2 considers the issues identified in the Task Force Report that continue to be of concern. Chapter 3 sets out new difficulties that Member countries have with the revised Regulations as presently drafted and puts forward a number of recommendations to deal with these difficulties. Chapter 4 provides a summary of the Recommendations and proposals for follow-up.

#### **Legislative Background**

1.5 The proposed Regulations issued in January 1992 were intended to provide guidance in implementing the amendment to Section 482 made by the Tax Reform Act of 1986, which requires that consideration for intangible property be commensurate with the income attributable to the intangible. The legislative history stated that this change was intended to assure that the division of income between related parties reasonably reflects the economic activities each undertakes. The legislative

history also expressed concern that insufficiently stringent standards had previously been used in determining whether a controlled transfer was comparable to an uncontrolled transfer.

1.6 When the U.S. issued the proposed Regulations, the Department of the Treasury requested comments from treaty partners and from other interested parties to be provided before 23 May 1992. Subsequently this period for comment was extended to July 1992.

1.7 The proposed Regulations aroused considerable interest both among Member countries of the OECD and among companies and practitioners in both the United States and elsewhere. The proposed Regulations were discussed by the Committee on Fiscal Affairs -- the main tax policy body of the OECD -- at its meeting in June 1992, at which time it was agreed to establish a special Task Force to undertake a detailed examination of the proposed Regulations. The Task Force Report was finalized by the end of December and passed to the U.S. Administration. In January 1993, the report of the Task Force was published by the OECD.

1.8 Many of the Recommendations of the Task Force have been taken into account in the revised Regulations and the Task Force generally welcomes the direction taken. By adopting a more flexible approach to the methods that can be used for the determination of a transfer price and by placing greater emphasis on the facts and circumstances of individual cases, there is now less risk that these Regulations will produce results that are incompatible with the arm's length standard. Nevertheless, there remain features of the revised Regulations that continue to give rise to concerns. This report identifies these problems and attempts to put forward solutions to deal with them.

## CHAPTER 2

### ISSUES OF CONTINUING CONCERN

#### A. General comments

2.1 The Task Force welcomes the substantial changes made by the United States to the proposed Regulations and the fact that the United States adopted many of the recommendations of the Task Force. The Task Force is particularly pleased to see a reaffirmation of the arm's length standard. By putting greater emphasis on facts and circumstances of individual cases, there is less of a risk that the regulations will produce results that are incompatible with the arm's length standard. A number of changes reflect a move towards greater consistency with the arm's length standard such as the removal of the overly restrictive sound business judgment rule, the introduction of the best method rule, and the elimination of the comparable profits method (CPM) as a mandatory check on other methods.

2.2 Other positive changes include increased flexibility, the elimination of a strict priority of methods, the preference for transaction-based methods, the acknowledgement that profit splits can also be a valid method of arriving at an arm's length result, and the fact that more than one method may be used to confirm results obtained under another method.

2.3 The Task Force hopes that the new administration will act swiftly to assure its treaty partners and the international business community that it supports the internationally accepted arm's length standard and the efforts by the former administration reflected in the revised Regulations to establish rules consistent with that standard.

2.4 Some of the concerns identified in the Task Force Report continue to be of concern in the revised Regulations. These issues are discussed in this Chapter. For ease of reference, these issues are presented in the order in which they appear in the Task Force Report.

#### B. Compatibility with the arm's length standard

2.5 One of the main issues raised by the Task Force in connection with the proposed Regulations issued by the United States in 1992 was the consistency of the regulations with the arm's length standard. Of particular concern was the commensurate with income standard applicable to transfers or licenses of intangible property that was added to section 482 by the 1986 Tax Reform Act. The Task Force Report indicates that to the extent that the implementation of the commensurate with income standard involves the use of hindsight, there is a risk that the arm's length standard will be violated because the application of the arm's length standard depends on the evaluation of the facts and circumstances surrounding transactions at the time they take place. The Task Force Report suggests that the inconsistency between profit approaches used to implement the commensurate with income standard and the arm's length principle could be resolved by limiting the application of such methods

to profits that were predictable or reasonably foreseeable by the taxpayer at the time the transaction was entered into. The Task Force concluded that "as long as the objective is to exclude from consideration all events which were not known and could not reasonably have been predicted by the parties at the time the transfer was made, the Task Force would not regard the arm's length standard as necessarily having been breached, although this could raise serious practical problems." The revised Regulations do not take such a narrow approach. (A more detailed discussion of the periodic adjustments provisions is provided in Section H below).

2.6 The Task Force was also concerned about the compatibility of the comparable profits method with the arm's length standard. The Task Force recognized that the use of a comparable profits method may be appropriate as a method of last resort to determine an arm's length price or to check the results obtained under other methods, but strongly endorsed the 1979 OECD Report view that profit comparisons should be made with care and that "exceptional profits or losses" do not necessarily reflect an attempt to use transfer prices as a way to shift profits.

2.7 Although the revised Regulations have reduced the importance of the comparable profits method by eliminating the requirement that it be used to check the application of other methods and by suggesting a preference for transaction-based methods, Member countries are concerned, as discussed further below, that the comparable profits method may in practice become the predominant method used by the IRS. Recommendations with respect to periodic adjustments and the comparable profits method are provided below.

### **C. Application of the revised Regulations in the context of a mutual agreement procedure or arbitration process**

2.8 The Task Force Report identifies the application of the proposed Regulations in the context of a tax convention's mutual agreement procedure or arbitration process as one of two fundamental issues affecting international tax arrangements raised by the proposed Regulations (the other being consistency with the arm's length standard). The concern was that the results of the methods prescribed by the proposed Regulations would not be accepted by other countries, which would lead to economic double taxation and a disruption of international trade (e.g., if the United States rejects the application of a method due for instance to the taxpayer's failure to satisfy reporting and documentation requirements, but the U.S. treaty partner considers that method to be the most appropriate in the circumstances). The Task Force Report suggests that these concerns could be eliminated to some extent if the United States were to confirm that the United States competent authority would not be bound to use the approaches prescribed by the Regulations in attempting to reach agreement with a treaty partner under a mutual agreement procedure of a tax convention, and that the rules of the Regulations would not be required to be applied in the context of arbitration permitted under a tax convention. Such a confirmation was deemed to be consistent with the practice of other OECD Member countries in resolving cases through the use of the mutual agreement procedure. The revised Regulations do not include such a formal confirmation.

2.9 Because the revised Regulations contain provisions that may conflict with the approaches of other Member countries to transfer pricing, such as the comparable profits method, periodic adjustments, and compensating adjustments, Member countries continue to believe that the United States should provide assurances that it does not consider itself bound to apply the rules set forth in the revised Regulations in the context of a mutual agreement procedure or arbitration process under a tax convention. The Task Force accepts that the Regulations may not be an appropriate place to comment

on the application of the Regulations in the context of a mutual agreement procedure or arbitration process provided for in a double taxation agreement. However, it is felt that some form of official confirmation on this issue is needed.

2.10 **Recommendation on application of the revised regulations in the context of a mutual agreement procedure or arbitration process:**

**It is recommended that the United States issue a general policy statement confirming that it will not be bound by the revised Regulations when dealing with a case through the mutual agreement procedure or arbitration process of a tax convention.**

**D. Concentration on abusive cases**

2.11 The Task Force acknowledges that positive steps were taken to reduce the importance of the comparable profits method. These steps include the intended expression in the best method rule of a general preference for methods based on stricter comparability (i.e. a preference for transaction-based methods over profit-based methods) and the elimination of the CPM as a mandatory check on the results obtained from application of other methods. However, because of the importance of the concerns expressed in the Task Force Report, the Task Force recommends that the United States clarify that by effectively limiting the scope of the CPM to cases where a transaction-based method cannot reasonably be applied, the best method rule effectively adopts the Task Force recommendation that CPM be used only as a method of last resort. The Task Force continues to be of the view that CPM should be used only in abusive cases and as a method of last resort (for example, CPM may be used in a case where no other method is more appropriate or can reasonably be applied with the result that both the taxpayer and administrations agree that its use on a consistent basis will produce an acceptable result for practical purposes).

2.12 **Recommendation on concentration on abusive cases:**

**For the reasons set forth in the Task Force Report, especially as the Task Force recognizes that the CPM remains at the experimental stage and requires further testing before its precise impact in the transfer pricing area can be determined, it is recommended that to the extent that the CPM is used to determine the amount of the adjustment to be made in a particular case, it should be clarified that it should only be used in abusive cases and as a method of last resort (for example, CPM may be used in a case where no other method is more appropriate or can reasonably be applied with the result that both the taxpayer and administrations agree that its use on a consistent basis will produce an acceptable result for practical purposes).**

**E. Priority of methods**

2.13 The introduction of the best method rule to replace the strict ordering of methods and the provision of standards to determine comparability between controlled and uncontrolled transactions are positive developments that make the revised Regulations more flexible for both taxpayers and the IRS. However, the Task Force is concerned that because of the increased flexibility the IRS examiners now

have in selecting a method, they may move too quickly to the conclusion that the CPM is the best method. IRS examiners may be inclined to resort to the CPM in most cases because it operates within a standard of comparability that is easier to satisfy than is the case for the other methods identified in the revised Regulations and because the IRS is not required to prove the inapplicability of other methods before using the CPM. Therefore, the Task Force is worried that the CPM will be used routinely and taxpayers will be forced to defend themselves by seeking data establishing the appropriateness of other methods, even though the availability of the necessary data is very limited to them. In particular, in the case of intangible transfers, the comparable uncontrolled transaction method would appear to require a standard of comparability in relation to profit potential that would be very difficult to demonstrate satisfactorily in practice. If this is the case, the result would be to lead examiners too quickly to the CPM in cases involving intangibles. This is an undesirable result in light of the preference expressed for transaction-based methods over profit-based methods (this preference being also relevant to the possible application of a profit-split method as now provided in the revised Regulations).

2.14 Another issue raised by the adoption of the best method rule is whether the revised Regulations would allow "the evidence of all methods to be used in conjunction" as the Task Force previously recommended. It seems that a method may be displaced by another method if that method provides a more accurate measure of the arm's length result. Furthermore, only one method may be used to produce a range of arm's length results.

2.15 The revised Regulations do acknowledge the use of multiple methods but only give guidance if two or more methods produce inconsistent results. This would appear to support a single best method approach rather than a multi-method approach as advocated by the Task Force. Where there is a conflict between the results derived from the application of two or more methods, the revised Regulations suggest taking another method into account. The Task Force approach seems more flexible. Where there are fundamental contradictions between the results of applying two or more methods, the Task Force took the view that an attempt should be made to reach a conclusion that was satisfactory from a practical viewpoint, taking into account the facts and circumstances of the case and also the mix of evidence available provided the results were consistent with the arm's length principle. For example, this would not rule out the possibility of a range of arm's length results, the upper end of which being determined by one method and the lower end of it being determined by another method. An issue that is not clear with respect to the application of the best method rule is whether in providing an analysis of why the method used by the taxpayer is the most accurate measure of an arm's length result, the taxpayer will in practice be required to disprove other methods. This would impose a fairly significant burden on taxpayers. Further clarification on this point would appear to be necessary.

2.16 **Recommendation on the priority of methods:**

**Given the stated preference in the revised Regulations for transactional methods for determining intercompany transfer prices, it would be desirable if such a preference were clearly reflected in the process leading to the choice of a method by examiners.**

**As recommended in the Task Force Report, the revised Regulations should allow the evidence of all methods to be used in conjunction to determine transfer pricing adjustments.**



## **F. Lack of available data to implement the CPM**

2.17 The Task Force continues to be concerned about the lack of availability to taxpayers and tax authorities of the information needed to apply the CPM. The Task Force Report recommended that the data used to apply the CPM be drawn from information that is available to the public or to which a taxpayer could reasonably be considered to have access or from other information that is available to the tax authorities and that could be shared with the taxpayer and, if necessary, with the competent authority of the appropriate tax administration in accordance with the provisions of tax treaties relating to mutual agreements and exchange of information. This issue is not addressed by the revised Regulations and therefore continues to raise the problems identified in the Task Force Report. However, the Task Force recognizes that, in practice, the sharing with taxpayers of data relied upon by the IRS does not appear to have presented problems in the past.

### **2.18 Recommendation on the lack of available data to implement the CPM:**

**The Task Force reiterates its initial recommendation that the data used for the purposes of the CPM to determine the arm's length range be drawn from information that is available to the public or to which the taxpayer could reasonably be considered to have access or from other information that is available to tax authorities that could be shared with the taxpayer. All such data used by an examiner in constructing the arm's length range for the purposes of the CPM should be shared with the taxpayer and, if necessary, with the competent authority of the appropriate tax administration in accordance with the provisions of tax treaties relating to mutual agreements and exchange of information.**

## **G. Difficulties in the application and role of the CPM**

2.19 The comparability standard of the CPM is very loose and not defined with sufficient precision. The comparables "need only be broadly similar and significant product diversity and some functional diversity ... is acceptable". Because the comparability standard of the CPM is much looser than the standards under the comparable uncontrolled price, resale price, cost plus, and comparable uncontrolled transaction methods there is a concern that in practice the CPM will become the predominant method. For example, in the case of intangible transfers, the comparable uncontrolled transaction method would appear to require a standard of comparability in relation to profit potential that would be very difficult to demonstrate satisfactorily in practice. An undesirable priority of methods could prevail in practice if the methods other than the CPM are so circumscribed by the revised Regulations that their use became infrequent or exceptional. The United States has indicated that this should not be the case because the operation of the best method rule should favour the use of transaction-based methods requiring more rigid comparability and that the differing comparability standards should be viewed in conjunction with the best method rule.

2.20 In order to avoid an undesirable priority of methods in practice, the revised Regulations should make it clearer that methods that require more rigid comparability are more appropriate methods than are other methods that require less comparability even if the latter relatively satisfy other factors such as data completeness or accuracy of adjustments. This will give emphasis to transaction-based methods, which is what the United States indicated was its intention.

2.21 In addition to the loose standard of comparability, there is no requirement to adjust arm's length results to achieve greater consistency. Constructive operating profits derived from profit level indicators of uncontrolled parties who are only broadly similar would not necessarily achieve an arm's length result. If appropriate adjustments cannot be made to the profit level indicators of the comparable parties, these comparable parties should not be used to determine the arm's length range.

2.22 **Recommendation relating to the application and role of the CPM:**

**It is recommended that the CPM's standards of comparability be more precisely defined, in particular in relation to their interaction with the best method rule.**

**To prevent IRS examiners from going too quickly to the CPM, it is recommended that the revised Regulations make it clearer that methods requiring stricter comparability are more appropriate than methods with looser comparability standards even if the other factors of the best method rule have been met. This concept may be inherent in the best method rule but should be explicitly stated.**

**It is also recommended that adjustments of profit level indicators of comparable parties be required to achieve greater consistency. If appropriate adjustments cannot be made, the party should not be used as a comparable.**

**H. Application of periodic adjustments**

2.23 The Task Force acknowledges that the revised Regulations take into account part of the Task Force's recommendation with respect to periodic adjustments. As noted in paragraphs 3.64 and 3.65 of the Task Force Report, there may be cases where it is difficult to ascertain the profits that were reasonably foreseeable at the time a transaction was entered into. In such cases, there may be a need to consider whether a retrospective adjustment is required. However, as noted above, the Task Force continues to hold the position that periodic adjustments should be restricted as far as possible to truly abusive cases and to cases where the taxpayer fails to provide the tax authorities with the information reasonably required to support the transfer prices in order to avoid inconsistency with the arm's length standard.

2.24 Transfers of intangibles involving the payment of royalties over periods exceeding one year are different from the sales of goods in two respects: the property transferred is usually more difficult to define and to value than a tangible good for the purpose of using a method that relies on comparables; and, perhaps more importantly, payments for the intangible may span over several years, unlike payments for goods, which are usually lump sums.

2.25 However, the fact that the payment for an intangible takes the form of a multi-year royalty should not change the criteria one uses to determine whether a price is consistent with the arm's length standard. An arm's length price is generally determined at the time a transaction is entered into. If normally in a comparable uncontrolled relationship, parties do not include a price adjustment clause in their long term agreements, a subsequent adjustment to the price by the tax authorities is in conflict with the arm's length principle. If on the other hand parties in an uncontrolled relationship would insert

such an adjustment clause, an adjustment should only be made from the year that clause would have come into effect.

2.26 This is not to say that a new arm's length price cannot be determined in years following the initial agreement. If, for example, the parties decide to modify the terms of the agreement and unrelated parties would do the same thing in the same circumstances, or the agreement ceases to reflect the functions actually carried out by the parties, ex post, then a new agreement is either formally or de facto in application, and such agreement would require the determination of a proper transfer price. However, determining a new transfer price in such cases is quite different from making adjustments in arm's length prices, in disregard of contractual arrangements between the parties, and exclusively on the basis of the actual income attributable to the intangible.

2.27 The two exceptions to periodic adjustments, although broader than the exceptions provided in the proposed Regulations, continue to be too narrow and of limited use. The set of conditions for avoiding periodic adjustments differs according to whether the comparable uncontrolled transaction method (CUT) or another method was initially used to determine the transfer price. Six conditions must be met when the CUT method is used; four conditions apply when other methods are used. For the most part, the conditions seek to ensure that the controlled agreement between the parties is formal, that the consideration for the first year in which consideration was payable is arm's length, and that the functions performed by the controlled parties have not changed over time. When the CUT method is used, additional conditions require that the controlled and uncontrolled agreements be comparable and that the terms of the uncontrolled and controlled agreements not be changed.

2.28 A further condition imposed regardless of the method used is the requirement that the total profits actually earned or the total cost savings realized by the controlled transferee from the use of the intangible in all open years be not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled transaction was entered into. No distinction is made among the different factors that may explain the difference between forecast and actual profits. It seems contrary to the arm's length standard to deny the exception to periodic adjustments merely on the grounds of the size of the unforeseeable profits or savings.

2.29 As a result, ex post adjustments could be made to a consideration -- despite the fact that the controlled and uncontrolled agreements remained comparable over the period and the functions performed by the controlled parties did not change over time -- only because actual profits proved to be somewhat different from those forecast when the agreement was entered into. An adjustment in such a circumstance seems difficult to reconcile with the arm's length standard.

2.30 No allowance is made for the fact that the difference between actual and forecast profits can be attributable to factors unforeseeable by the controlled taxpayer at the time the transaction was entered into (e.g., market factors like greater/lower demand for the product, greater/lower market price for the product, etc). To the extent that the contract does not provide for the adjustment of consideration to reflect potential changes in profitability attributable to unforeseen circumstances, tax authorities should not be allowed to second-guess such an agreement. The unexpected profit or loss attributable, for example, to market risk should remain with the party that assumed that risk under the terms of the agreement, generally the manufacturer or distributor.

2.31 The exception applicable to taxpayers that have used the comparable uncontrolled transaction method requires that the taxpayer have access to written agreements relating to the uncontrolled transaction on which they relied to set their transfer prices. This condition is problematical because it will exclude those cases in which the taxpayer is not a party to the uncontrolled transaction.

2.32 There is also a concern that there is a conflict between the arm's length standard and the provision that allows the district director to make an adjustment to the amount charged for an intangible even where there was a determination in an earlier year that the amount charged for the intangible was arm's length. It is recommended that there be an exception that would preclude the making of periodic adjustments where there were factors beyond the control of any member of the controlled group and these were neither anticipated nor reasonably foreseeable.

2.33 **Recommendation concerning application of periodic adjustments:**

**It is recommended that the Task Force's original recommendation that periodic adjustments be confined to truly abusive cases be adopted. Although it is recognized that the exceptions to periodic adjustments were broadened, the Task Force recommends deletion of the requirement limiting the total profits actually earned or the total cost savings actually realized by the controlled transferee from the exploitation of the intangible in all open years to between 80% and 120% of the foreseeable profits or cost savings, because an adjustment in such circumstances would seem difficult to reconcile with the arm's length standard.**

**It is also recommended that once a transaction has been determined to have been made at arm's length, adjustments should not be made in later years where there were factors beyond the control of any member of the group and these factors were neither anticipated nor reasonably foreseeable.**

**I. Treatment of tangibles with intangible elements**

2.34 The recommendations of the Task Force are largely reflected in the revised Regulations with respect to the treatment of tangibles. However, the methodology to be used to check the transfer price of property that involves both tangible and intangible elements is not clear. The revised Regulations provide that because the methods to be applied to transfers of tangible property do not adequately account for significant, non-routine intangibles that may be transferred or used with the sale of property, it may be necessary to adjust the results obtained using the tangible methods with the "principles" of the intangible methods. A similar statement is made with respect to the transfer of property that includes tangible and routine intangible elements.

2.35 Although the treatment of tangibles with intangible elements has been made much more flexible, it is still not clear whether a can of tuna fish sold under a brand name would fall under the tangible rules. If the brand name is regarded as a significant, non-routine intangible, the results of the application of the tangible method may need to be adjusted with the intangible methods. Further guidance in this area is needed because it is not clear how such an adjustment would be made, particularly given that neither the cost plus nor resale price method would ordinarily apply in the case of transfers of intangibles.

2.36 **Recommendation relating to the treatment of tangibles with intangible elements:**

**It is recommended that further guidance be provided as to how the intangible methods are to be applied in the transfer of property that involves both tangible and intangible elements.**

## CHAPTER 3

### NEW ISSUES

#### A. Comparability standard of the comparable uncontrolled price method (CUP)

3.1 The revised Regulations seem to have a different, more stringent comparability standard for the CUP method than has been used in the past. The preamble of the revised Regulations explains that "although the text of this rule differs somewhat from its counterpart in the final regulations, the changes were intended to be clarifications of the current standard rather than substantive changes." However, the specific text of the revised Regulations suggests otherwise.

3.2 The revised Regulations provide that "for purposes of the comparable uncontrolled price method, transactions are considered comparable only if the tangible property and circumstances of the controlled transaction are substantially the same as those of the uncontrolled transaction. The tangible property and circumstances of an uncontrolled transaction will be considered substantially the same as those of a controlled transaction only if any minor differences between the transactions either have no effect on the amount charged, or can be accounted for by a reasonable number of adjustments. If there are material differences between the controlled and uncontrolled transactions, other methods must be applied such as the resale price method ..., the cost plus method ..., or the comparable profits method ...".

3.3 Since the CUP is generally preferable to other methods, the Task Force considers that the CUP can be applied even where differences are material, if their effect on the prices concerned is definite and reasonably ascertainable. In fact, the same kind of adjustments may be necessary to reach an accurate comparability of margins and mark-up when the Resale Price or the Cost Plus Methods appear to be applicable. If such adjustments are not allowed, examiners could move too quickly to other less accurate methods, like the CPM.

#### 3.4 Recommendation on the comparability standard of the CUP:

**It is recommended that the comparability standard of the CUP method be amended to allow for material differences if the effect on price is reasonably ascertainable.**

#### B. Comparability standards of the CUT

3.5 The CUT method applies to cases where an uncontrolled transaction is comparable to a controlled transaction, in practice when there exists a market in which a comparable intangible is being traded. Three conditions must be met to establish that the controlled and uncontrolled intangibles are

comparable. Eight additional factors are examined to determine if the "circumstances" of the controlled and uncontrolled transactions are comparable.

3.6 Among the three conditions required to establish the comparability of intangibles, the third condition may be problematic. The condition requires that both intangibles have substantially the same profit potential, as measured by the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, taking into consideration the capital investment and start-up expenses required, the risks to be assumed and other relevant considerations.

3.7 This requires the taxpayer to establish the profit potential of his own intangible, which may sometimes prove to be highly speculative. It also requires the taxpayer to gather data and knowledge about the uncontrolled intangible in order to establish its profit potential. This may be difficult, if not impossible, to obtain because while the uncontrolled transaction may be an arm's length transaction, it is not necessarily a "public" transaction the details of which are readily available and the uncontrolled transaction may be carried out by a competitor who, understandably, will not be anxious to share the financial aspects of its comparable intangible with its rival.

3.8 Compliance with this condition could prove to be impractical, thus making the CUT method virtually inaccessible to taxpayers, even in cases when uncontrolled intangibles exist and all other conditions are met. When the CUT method cannot be used, it is likely that the IRS would then turn to the CPM, which means, as noted above, that the CPM would become the norm rather than the exception.

3.9 The concern regarding the "profit potential" test could be reduced significantly -- without compromising its basic policy purpose -- by its being worded in the negative. In other words, a taxpayer could not use a comparable where it ought to have been clear at the outset to the taxpayer that the profit potential from the two properties was so different that the situations could not reasonably be considered comparable. Such a modification would ease the burden of proof of the taxpayer, and would prevent denying use of the comparable where the taxpayer has a reasonable expectation that the profit potential of the controlled and uncontrolled properties is similar, but is unable to actually prove that the profit potentials are nearly equal.

3.10 The eight conditions examined to determine whether the circumstances of the controlled and uncontrolled transactions are comparable appear to be reasonable if looked at individually but impose a very high standard of comparability when taken together. Information about some of these factors -- e.g., uniqueness of property, expected economic life of the property, provisions of third party agreements, etc. -- may be difficult, if not impossible to obtain for the controlled taxpayer. The inability to obtain such information, in turn, would preclude meeting the conditions and, thus, prevent the use of the method.

3.11 The concerns regarding the application of the CUT method would be significantly diminished with the retention of the comparable adjustable transaction method included in the 1992 proposed regulations -- without the requirement that the results obtained be confirmed with the CPM. Retention of the method would permit adjustments to the sales prices for factors which are quantifiable. Provision for such adjustments is made with respect to transfers of tangible property.

3.12 The CUT method is the most appropriate method to use in the case of transfers of intangibles for which comparables exist. Taxpayers should be given every possible chance to use this method even if the uncontrolled property and transaction are not in every respect comparable. It would be unfortunate if the high standards required for the utilisation of the CUT method were to overly restrict the use of the method to near-perfect cases of comparability and of data availability, when adequate comparables exist.

3.13 **Recommendation on the comparability standards of the CUT method:**

**In order to reduce what might otherwise be an impossible compliance burden, it is recommended that the "profit potential" test of the CUT method be revised to prohibit the taxpayer from using a comparable where it should have been clear to the taxpayer at the time the transaction was entered into that the profit potential from the two properties was so different that the situations could not reasonably be considered to be comparable.**

**It is also recommended that the comparable adjustable transaction method included in the 1992 proposed Regulations be reintroduced but without the requirement of a check of the results with the CPM. This would provide taxpayers greater access to a CUT method.**

**C. Problems with comparability of controlled and uncontrolled transactions**

3.14 In general, the Task Force views the revised Regulations as providing considerable guidance on factors which determine comparability. However, the consideration of alternatives realistically available to a buyer or seller would appear to be making a significant change to the nature of the transaction under review. The revised regulations provide that allocations will be based on the taxpayer's actual transactions except where a controlled transaction lacks economic substance. However, "the district director may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the district director may adjust the consideration charged in the controlled transaction based on the cost of the alternative, but will not restructure the transaction as if the alternative had been adopted by the taxpayer."

3.15 As a rule, the determination of transfer prices should be made on the basis of actual transactions and actual business choices. Whilst the Task Force recognizes that the revised Regulations provide that this determination must be based on the taxpayers' actual transactions, there is concern that the examination of alternatives may nevertheless be used to second-guess the appropriateness of bona fide business decisions. The construction of alternative business arrangements for the purpose of determining transfer prices would be, at best, an uncertain enterprise and could prove to be arbitrary. In addition, if alternative transactions are to be considered, many factors other than costs, such as the opportunities and risks involved in production, would need to be taken into account.

3.16 Furthermore, no such statutory or regulatory flexibility may be afforded to the revenue authority in the jurisdiction in which the other controlled corporation resides. Thus, double taxation



is likely where an adjustment is based on an alternative transaction that the taxpayer could have entered into.

3.17 Another factor that causes concern and may be inconsistent with the arm's length standard is the first step in the risk analysis. The risk analysis required by the revised Regulations "states that the district director must determine which controlled taxpayer bears the risk which includes a consideration of whether the income earned by [the] controlled taxpayer over a reasonable period of time is commensurate with the risk assumed." The use of hindsight in transfer pricing methodologies, as previously stated, is generally inconsistent with the arm's length standard.

3.18 **Recommendation on the problems with comparability of controlled and uncontrolled transactions:**

**It is recommended that the alternative business transactions realistically available to the taxpayer not be used to second-guess the appropriateness of bona fide business decisions except where the transaction lacks economic substance.**

**It is also recommended that the use of hindsight be eliminated from the risk analysis required by the revised Regulations.**

**D. Adjustments to the midpoint of the arm's length range**

3.19 Application of the arm's length range concept to all transfer pricing methodologies is a welcome development. However, there is some doubt as to whether the general rule requiring adjustment to the midpoint of the range is appropriate. Although the mid-point may be as valid as any other point, it may be unfair to place the taxpayer at the midpoint if there is an uneven concentration of arm's length prices. It may therefore be more accurate to put the taxpayer within the range and towards the end of the range that best reflected the facts and circumstances of the controlled taxpayer.

3.20 **Recommendation relating to adjustments to the midpoint of the arm's length range:**

**It is recommended that the revised Regulations be modified to require adjustments to be made to the point within the range that best reflects the facts and circumstances of the controlled taxpayer.**

**E. Profit split approach**

3.21 The Task Force is concerned that the administrative requirements for using the profit split approach may be overly restrictive. For example, where the profit-split approach is the most appropriate of the available pricing methods, a taxpayer should be able to use the method without advance reporting and documentation obligations that are not required for other methods. The Task Force Report discussed the advantages of a profit split approach over the CPM and suggested that the CPM not be treated as a more favoured method. However, under the regulations, the CPM might

mistakenly be considered a more favoured method because the profit-split is subject to a higher level of reporting and documentation requirements.

3.22 A profit split is only available if both controlled taxpayers own valuable, non-routine intangibles either developed by the taxpayer or acquired from uncontrolled taxpayers. Therefore, it would not appear to cover more conventional transfers of a single intangible from a parent company to a manufacturing subsidiary in a foreign jurisdiction, or the transfer of more conventional intangibles. Whether the method is appropriate should be a question of fact to be determined in accordance with the best method rule. This approach would require a significant liberalization of the conditions under which the method may be used. Such a liberalization would enable taxpayers that are otherwise prevented from using the CUT method to rely on a profit split, instead of the CPM or other methods, provided the use of a profit split is consistent with the best method rule.

3.23 The revised Regulations reintroduce the basic arm's length return method (BALRM), which raises concerns because it relies on hard-to-find comparable rates of return with respect to every function performed in connection with the intangible sold or licensed, instead of relying on generally known data involving more or less comparable situations. Further, there are doubts as to whether unrelated parties do apply functional analysis to determine a sales price or royalty. Substantial manpower would be needed to perform such an analysis, especially since it should be performed during the full life-time of the intangible and not limited to the time of sale or the outset of the licensing agreement. The revised Regulations' BALRM approach does not remove these difficulties.

3.24 The Task Force acknowledged that more work is necessary to determine the proper application of the profit-split method. This will be done in the context of the revision of the OECD 1979 Report.

3.25 **Recommendation relating to profit splits:**

**The Task Force recommends to eliminating the advance reporting and documentation obligations required for the use of the profitsplit method and applying the best method rule to determine whether use of such a method is appropriate.**

**F. Difficulties created by reporting prices other than actual prices**

3.26 The revised Regulations allow taxpayers, where necessary to reflect an arm's length result, an opportunity to report the results of their controlled transactions based on prices different from those recorded in their books and records. However, this may result in double taxation or non-taxation of income if the other country does not make corresponding adjustments to account for those made by the taxpayer. The laws of some countries may not permit the reporting of amounts other than the amounts agreed to by the parties for purposes of the transaction. This issue requires further study in connection with the revision of the OECD 1979 Report.

**G. Compliance burden on taxpayers**

3.27 The revised Regulations increase the flexibility of the acceptable arm's length methodologies and results on the one hand, but impose onerous procedural requirements on taxpayers on the other.

Although requiring some contemporaneous documentation is acceptable, it seems unduly burdensome to require taxpayers to conduct extensive studies that depend on information that may not be available, before determining each transfer price. The documentation requirements should be realistic and not excessive, particularly in the case of the corresponding regulations governing transfer pricing penalties. Further, a taxpayer should not be deprived of the opportunity to use a method even if the method is not documented before the return is filed.

3.28 Under the revised regulations, a taxpayer who engages in a variety of businesses will have to examine numerous tax requirements before filing a return that reports transactions with related parties. Requiring taxpayers to perform excessively intricate tax analyses before entering into transactions will distort the normal practice of business and deter international trade and foreign investment, although it is accepted that some appropriate analysis should be required before the taxpayer files its return.

3.29 **Recommendation on compliance burden on taxpayers:**

**It is recommended that a taxpayer's documentation requirements be limited to information to which the taxpayer could reasonably be expected to have access and that there be a limit on the intricate tax analyses required of taxpayers before entering into transactions in order not to disrupt international trade and foreign investment. Further, a taxpayer should not be deprived of the opportunity to use a method even if the method is not documented before the return is filed.**

**H. Safe harbor**

3.30 The Task Force recommended that the United States provide a safe harbor for small businesses in order to avoid the compliance burden associated with the use of the comparable profits method. Acknowledging that the concept of safe harbors requires further work by the OECD, the Task Force was reluctant, in view of the limited time available to it, to make any specific recommendations on the safe harbor.

3.31 Under the safe harbor rules of the revised Regulations, no adjustment will be made when a qualifying taxpayer elects the safe harbor provisions. The electing taxpayer is required to determine its taxable income by applying profit level indicators to be published in a revenue procedure by the IRS. Since the profit level indicators have yet to be disclosed, it is not possible to assess them.

3.32 As the Task Force Report mentions, difficulties would arise if a safe harbor provision resulted in the attribution of more profit to the United States than the subsequent application of the arm's length standard would attribute. The preamble of the revised Regulations states that ... some taxpayers may find that the results they achieve under the safe harbor are somewhat less favourable than they could have achieved if they did not elect the safe harbor..." which suggests that the risk of a shift of profits to the United States may be unavoidable. In order to avoid such a result, the Task Force Report suggests adopting an approach "that is likely to give the taxpayer a more favourable result than the strict application of the arm's length standard." It is hoped that the profit level indicators adopted will attempt to achieve such a result.

3.33 There is also concern about the inability to revoke the election to use the safe harbor without the consent of the Commissioner. If such consent is difficult to get, taxpayers will be forced to shift income to the United States to meet the profit level indicator even where it is apparent that their actual taxable income is below the indicator.

3.34 Permanent establishments are excluded from the safe harbor benefits. To the extent that such exclusion may violate the non-discrimination provisions of tax treaties, it should be reconsidered.

3.35 **Recommendation with respect to the safe harbor:**

**It is recommended that the profit level indicators be chosen with a view to providing the taxpayer with a result that is likely to be more favourable than that which would be achieved under a strict application of the arm's length standard and that the safe harbor be applied in a non-discriminatory manner.**

## CHAPTER 4

### CONCLUSIONS

#### A. Main Recommendations

4.1 The Recommendations set out below would, if adopted, alleviate the problems with the revised Regulations, as identified in this report. They would also ensure that the international consensus referred to above would be maintained.

4.2 The main recommendations are:

#### **Recommendation on application of the revised regulations in the context of a mutual agreement procedure or arbitration process:**

**It is recommended that the United States issue a general policy statement confirming that it will not be bound by the revised Regulations when dealing with a case through the mutual agreement procedure or arbitration process of a tax convention.**

#### **Recommendation on concentration on abusive cases:**

**For the reasons set forth in the Task Force Report, especially as the Task Force recognizes that the CPM remains at the experimental stage and requires further testing before its precise impact in the transfer pricing area can be determined, it is recommended that to the extent that the CPM is used to determine the amount of the adjustment to be made in a particular case, it should only be used in abusive cases and as a method of last resort (for example, CPM may be used in a case where no other method is more appropriate or can reasonably be applied, with the result that both the taxpayer and administration agree that its use on a consistent basis will produce an acceptable result for practical purposes).**

#### **Recommendation on the priority of methods:**

**Given the stated preference in the revised Regulations for transactional methods for determining intercompany transfer prices, it would be desirable if such a preference were clearly reflected in the process leading to the choice of a method by examiners.**

As recommended in the Task Force Report, the revised Regulations should allow the evidence of all methods to be used in conjunction to determine transfer pricing adjustments.

**Recommendation on the lack of available data to implement the CPM:**

The Task Force reiterates its initial recommendation that the data used for the purposes of the comparable profit method to determine the arm's length range be drawn from information that is available to the public or to which the taxpayer could reasonably be considered to have access or from other information that is available to tax authorities that could be shared with the taxpayer. All such data used by an examiner in constructing the arm's length range for the purposes of the comparable profit method should be shared with the taxpayer and, if necessary, with the competent authority of the appropriate tax administration in accordance with the provisions of tax treaties relating to mutual agreements and exchange of information.

**Recommendation relating to the application and role of the CPM:**

It is recommended that the CPM's standards of comparability be more precisely defined, in particular in relation to their interaction with the best method rule.

To prevent IRS examiners from going too quickly to the CPM, it is recommended that the revised Regulations make it clearer that methods requiring stricter comparability are more appropriate than methods with looser comparability standards even if the other factors of the best method rule have been met. This concept may be inherent in the best method rule but should be explicitly stated.

It is also recommended that adjustments of profit level indicators of comparable parties be required to achieve greater consistency. If appropriate adjustments cannot be made, the party should not be used as a comparable.

**Recommendation concerning application of periodic adjustments:**

It is recommended that the Task Force's original recommendation that periodic adjustments be confined to truly abusive cases be adopted. Although it is recognized that the exceptions to periodic adjustments were broadened, the Task Force recommends deletion of the requirement limiting the total profits actually earned or the total cost savings actually realized by the controlled transferee from the exploitation of the intangible in all open years to between 80% and 120% of the foreseeable profits or cost savings, because an adjustment in such circumstances would seem difficult to reconcile with the arm's length standard.

It is also recommended that once a transaction has been determined to have been made at arm's length, adjustments should not be made in later years where there were factors

beyond the control of any member of the group and these factors were neither anticipated nor reasonably foreseeable.

**Recommendation relating to the treatment of tangibles with intangible elements:**

It is recommended that further guidance be provided as to how the intangible methods are to be applied in the transfer of property that involves both tangible and intangible elements.

**Recommendation on the comparability standard of the CUP:**

It is recommended that the comparability standard of the CUP method be amended to allow for material differences if their effect on price is reasonably ascertainable.

**Recommendation on the comparability standards of the CUT method:**

In order to reduce what might otherwise be an impossible compliance burden, it is recommended that the "profit potential" test of the CUT method be revised to prohibit the taxpayer from using a comparable where it should have been clear to the taxpayer at the time the transaction was entered into that the profit potential from the two properties was so different that the situations could not reasonably be considered to be comparable.

It is also recommended that the comparable adjustable transaction method included in the 1992 proposed Regulations be reintroduced but without the requirement of a check of the results with the CPM. This would provide taxpayers greater access to a CUT method.

**Recommendation on the problems with comparability of controlled and uncontrolled transactions:**

It is recommended that the alternative business transactions realistically available to the taxpayer not be used to second-guess the appropriateness of bona fide business decisions except where the transaction lacks economic substance.

It is also recommended that the use of hindsight be eliminated from the risk analysis required by the revised Regulations.

**Recommendation relating to adjustments to the midpoint of the arm's length range:**

It is recommended that the revised Regulations be modified to require adjustments be required to be made to the point within the range that best reflects the facts and circumstances of the controlled taxpayer.

**Recommendation relating to profit splits:**

**The Task Force recommends eliminating the advance reporting and documentation obligations required for the use of the profitsplit method and applying the best method rule to determine whether use of such a method is appropriate.**

**Recommendation on compliance burden on taxpayers:**

**It is recommended that a taxpayer's documentation requirements be limited to information to which the taxpayer could reasonably be expected to have access and that there be a limit on the intricate tax analyses required of taxpayers before entering into transactions in order not to disrupt international trade and foreign investment. Further, a taxpayer should not be deprived of the opportunity to use a method even if the method is not documented before the return is filed.**

**Recommendation with respect to the safe harbor:**

**It is recommended that the profit level indicators be chosen with a view to providing the taxpayer with a result that is likely to be more favourable than that which would be achieved under a strict application of the arm's length standard and that the safe harbor be applied in a non-discriminatory manner.**

**B. Follow-up**

4.3 The Task Force believes that with the completion of this report, it has fulfilled the Mandate given to it by the Committee on Fiscal Affairs to review the U.S. 482 Regulations. Nevertheless, the Task Force feels that it would be necessary to continue the dialogue with the United States on the implementation of the revised Regulations. As noted in the 1993 Task Force Report and by numerous commentaries in the public and private sectors, the impact of the revised Regulations on taxpayers will, to a large extent, depend upon how they are implemented. In particular, the attitude of the IRS auditors will be crucial.

In that context, the Task Force suggests that:

- i) it would be useful if the U.S. were to agree to present to the Task Force the guidelines for IRS auditors that are currently being prepared.
- ii) at the December 1994 meeting, Working Party No. 6 could devote a half-day session to examining the operation of the Regulations. This review could examine any experience gained with transfer pricing audits (although it is recognised that this is unlikely to be



extensive by end 1994) and the compliance experience of taxpayers. BIAC could be invited to participate in part of this session.

4.4 The Task Force also recommends that the Temporary Regulations not be finalised before it completes its review of the OECD 1979 Report.