

TRANSFER PRICING **IRC SECTION 482**

Companies which transfer goods and services among offshore and related entities are subject to the provisions of Internal Revenue Code Section 482. Crucial to meeting these standards of objectivity is an independent analysis of the intercompany transfer prices. Four primary methods are considered acceptable, depending upon the circumstances.

Any intercompany pricing method – whether for transfers of tangible assets, or for loans or services – must be applied to comply with the following.

1. **Best Method Rule** – taxpayer determines the arm’s-length result of controlled transactions based upon: (1) the comparability of controlled and uncontrolled transactions, and (2) the quality of the data and assumptions.

2. **Comparability Analysis** – comparability of uncontrolled taxpayer transactions based upon:
 - functions performed
 - significant contractual terms
 - risks affecting price or profit
 - economic conditions affecting price or profit
 - property or services transferred

3. **Arm’s-Length Range** – a statistical range of all comparable uncontrolled transactions brought to a similar level of comparability and reliability.

Methods

One method is known as Comparable Uncontrolled Price (CUP). Prices of OEM sales of identical products form the basis for this method. However, this gross data must be adjusted to reflect value differences in contractual terms; use of intellectual property; and economic conditions affecting the control and uncontrolled services/products. One drawback to this technique is that internal transfer prices are typically company private; also, general averages from uncontrolled transactions may be insufficient to prevail upon audit or at trial.

The Gross Services Margin Method (GSMM) evaluates whether the amount charged in a controlled services transaction is arm’s-length by reference to the gross profit margin in comparable, uncontrolled transactions. Comparability under GSMM is particularly dependent upon similarity of services, risks borne, intangibles used in providing services or functions, and contractual terms.

The third approach is Services Cost Method (SCM). It evaluates whether the amount charged for covered services is arm's-length by reference to the total services costs with no markup. Covered services are also known as low margin services, whereby the markup on total services costs is less than or equal to 7 percent. A covered service does not contribute significantly to key competitive advantages, core capabilities or fundamental risks in the controlled group. Excluded from the use of SCM are these activities: manufacturing, extraction or processing natural resources, construction, resale, R&D, and engineering or scientific.

From the outset, a taxpayer using any of the above methods will usually have the fundamental disadvantages of incomplete or unreliable information. In contrast, the taxpayer has total access to complete and accurate information regarding his own revenue, production costs, and operating assets. Therefore, a calculation based on projected return on investment, using the taxpayer data, has inherent accuracy.

The best approach is known as CPM, Comparable Profit Method. Essentially, this method focuses on return on investment for the taxpayer, as compared with similar public company data. The most supportable opinion involves a refinement of CPM, in which transfer prices are determined based on the present value of projected future income.

CPM Procedure

The following analytical procedure is suggested as the best method for most firms, as a refinement of the CPM method. This method is based on the widely accepted marginal cost/marginal revenue model. The model allows maximum profit for each location, resulting in clear evidence of arm's-length pricing required by Section 482.

1. **Asset Value.** Determine the market value of all assets by location and product line, including intangible assets. The pricing must allow adequate yield on the investment for these assets, by location and product line.
2. **Discount Rate.** Calculate the cost of capital for each product line and location, based on the risk free rate for each country and product line risk, compared to public firms in similar markets.
3. **Market Demand.** Derive the demand curved for each product line based on price vs. quantity; estimate future shifts in the demand curved based on the product life cycle and promotion strategy.
4. **Supply Cost.** Derive the cost versus quantity curves for each product line, based on factory level cost plus required return on investment.
5. **Cash Flow.** Project future cash flow for each product line and location, using transfer prices designed to maximize profit, based on marginal revenue.
6. **Present Value.** Maximize the present value of future cash flow for each product line and location; iterate the model using alternative transfer prices to determine the optimum price.

For this refined method, the requirement for obtaining data from comparable firms is simplified; data from similar firms is limited to beta (variations in industry stock prices as an indication of risk) and the debt/capital ratios, which are reported for public firms. Demand curve data can be calculated from company records. This method does not require private data from competitors, such as individual transaction data or detailed cost data.

The projection of future cash flow is a standard approach for IRS economists; the method has been successfully used by the IRS to challenge allocations of intangible values under Section 338(h)(10) and international interest allocation under Sections 861 and 864. Accordingly, the taxpayer should select an expert that is highly proficient in econometric methods to allow effective defense of transfer pricing.