*Property Taxation Valuation Insights*

# Using Intercompany Transfer Price Methods to Segregate Tangible/Intangible Assets in Unit Valuation Property Tax Appraisals

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## Introduction

Many commercial and industrial property owners are assessed using the unit method (as opposed to the alternative summation method) of valuation for ad valorem property tax purposes. The unit (sometimes called unitary) method is a "top down" property valuation process.

In the unit method, the total value of the subject property is estimated collectively as a single bundle (or "unit") of operating assets. The summation method is a "bottom up" property valuation process. In the summation method, the total value of the subject property is estimated by adding (finding the "sum" of) all of the individual components of land, buildings and land improvements, and personal property. In theory, if properly applied, both methods should conclude the same defined value for the same bundle of taxable assets.

> *"In theory, if properly applied, both methods should conclude the same defined value for the same bundle of taxable assets."*

The unit method is often applied to taxpayers with (1) properties that cross multiple taxing jurisdictions, (2) properties that are simply too numerous to appraise individually, or (3) properties that are so operationally integrated as to be impractical to appraise individually. Taxpayers that are typically subject to the unit method of valuation include railroads, airlines, utilities, pipelines, cable TV systems, broadcast radio and TV stations, oil and gas refineries, mining operations, and complex, special-purpose production/processing operations.

The unit method is intended to be a particularly efficient process to appraise the operating assets of complex, special-purpose properties. Unfortunately, the unit method is not a particularly effective process to appraise the operating assets of complex, special-purpose properties if (1) not all of the subject operating assets are subject to property taxation or (2) not all of the subject operating assets are subject to property taxation at the same tax rate.

Unit valuation methods typically estimate the total value of all of the taxpayer's operating assets, including: (1) both real and personal and (2) both tangible and intangible. This methodological result presents a particular problem for jurisdictions that exempt intangible assets from property taxation—or that tax intangible assets at a different rate than tangible assets.

Taxpayers and taxing authorities often address this unit method practical problem by: (1) separately valuing the taxpayer discrete intangible assets, (2) subtracting the intangible asset values from the overall unit value, and (3) concluding the residual unit value that indicates the value of the tangible (taxable) operating assets. This residual procedure may work in theory, but it has practical application problems. Typically, the taxing authority may not have (1) the manpower resources or (2) the requisite financial and operational data to separately appraise the taxpayer discrete intangible assets. And, when the taxpayer provides this appraisal, the taxpayer and the taxing authority do not always agree on (1) the identification and (2) the valuation of the taxpayer discrete intangible assets.

## The Objective of Intercompany Transfer Prices

Another procedure to accommodate the use of the unit method is (1) to identify the portion of the overall taxpayer income (however measured) that is generated by the function of intangible assets and (2) to subtract this intangible income from the total unit income. The residual income will represent the portion of the unit income generated by the function of the tangible (taxable) assets.

This residual income can be capitalized using a variety of income approach (yield capitalization/direct capitalization) methods. The capitalization result would indicate the value of the taxpayer's operating tangible (taxable) assets. This residual income procedure is conceptually similar to the residual asset valuation procedure described above. Presumably, therefore, this residual income procedure will also have practical application problems.

However, these practical application problems may be resolved by using the tangible/intangible asset intercompany transfer pricing methods allowed under Internal Revenue Code Section 482. For decades, the Internal Revenue Service has been concerned that a domestic taxpayer could shelter income/avoid taxes by transferring tangible or intangible assets to a foreign affiliate.

The Service is concerned that a domestic taxpayer could avoid domestic taxes by transferring assets/allocating income to a low tax rate foreign country. Income could be shifted to the foreign country through the payment of a transfer price (typically, a royalty rate) to the foreign (but controlled) entity for the use of the transferred tangible/intangible assets. Likewise, the Service is concerned that a foreign taxpayer could avoid domestic taxes by not allocating sufficient income to the United States for the use of tangible/intangible assets that are owned/used by a domestic (and controlled) affiliate of the foreign taxpayer.

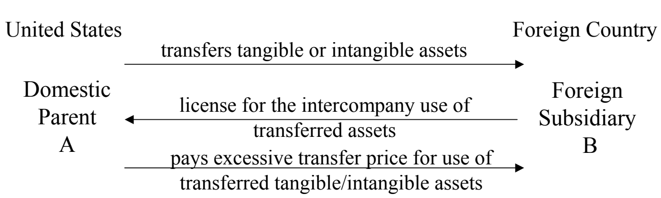
In order to appropriately reflect the income attributable to the use of transferred tangible/intangible assets, the Treasury promulgated rigorous and comprehensive regulations related to Section 482. These regulations describe in detail (with numerous illustrative examples) the allowable methods for determining the appropriate intercompany transfer price between controlled/related parties for the use of tangible/intangible assets.

These tangible/intangible asset transfer price regulations have been interpreted by the Internal Revenue Service and by practitioners for decades. Likewise, these regulations—and the specified transfer price methods—have been tested in and interpreted by the federal courts for decades. The transfer pricing regulations are updated when needed (including the currently proposed regulation updates issued in September 2003). And, the U.S. intercompany transfer price regulations are generally consistent with transfer price rules adopted by foreign taxing authorities in other major industrial countries.

> *"The Section 482 methods are designed to ensure that the transfer price for the use of the tangible/intangible assets is a fair, arm's-length price (no more and no less)."*

In broad concept, the Section 482 transfer price rules treat the related party tangible/intangible assets as if they were owned by a truly independent, arm's-length entity. Arm's-length prices are determined by the application of a specified set of approved economic analysis methods. The resulting tangible/intangible asset transfer prices are designed to appropriately allocate the income of the overall taxpayer between (1) the use of the subject tangible assets and (2) the use of the subject intangible assets. This is exactly the same objective as the use of the unit valuation method in ad valorem property taxation.

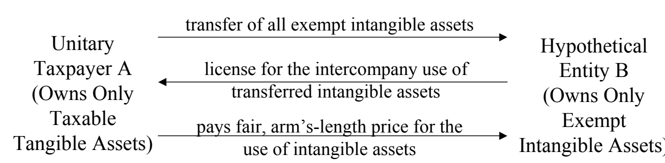
Typically, the Internal Revenue Service is concerned with an intercompany transaction like the following:




In the above scenario, the domestic taxpayer has the incentive to pay an excessive transfer price to its foreign affiliate located in a low/no tax rate country. This is because the intercompany payment would be a deductible expense in the United States, thereby reducing the taxpayer's domestic taxable income. The Section 482 methods are designed to ensure that the transfer price for the use of the tangible/intangible assets is a fair, arm's-length price (no more and no less). The Section 482 transfer price is intended to clearly reflect the domestic taxable income of the domestic taxpayer.

Both unitary taxpayers and taxing authorities should be interested in the following analogous—but hypothetical—intercompany transfer. The use of an intercompany transfer price analysis would allow for an income allocation between the unitary taxpayers and a hypothetical entity.

In this scenario, the unitary taxpayer would hypothetically transfer all of its exempt intangible assets to a related party company. This related party company would license back the use of the exempt intangibles at a fair, arm's-length price. Therefore, the total income of the taxable unit would be effectively allocated between (1) the income related to the function of the exempt intangible assets in the hypothetical entity and (2) the residual income related to the function of the taxable tangible assets in the unitary entity.




In the above scenario, the Section 482 methods would ensure that the unitary taxpayer/licensee pays a fair arm's-length transfer price for the "license" of the unit intangible assets from the hypothetical intangible asset entity licensor. This transfer price analysis would ensure that:

1. all unit income related to exempt intangible assets is transferred to the hypothetical entity and
2. all residual unit income related to the taxable tangible assets remains in the unit taxpayer entity.

The following discussion presents the framework for the intercompany transfer pricing of tangible/intangible assets for federal income tax purposes. The methods described are used to allocate the total income of a single multinational taxpayer between the intercompany use of tangible and intangible assets—as if the assets were owned by two unrelated taxpayers.

These same transfer price methods could be used to allocate the total unit income of a single property owner between the intercompany use of tangible and intangible assets—as if the assets were owned by two unrelated taxpayers.

## U.S. Regulatory Framework for Intercompany Transfer Pricing

The current U.S. tax rules concerning the intercompany transfer pricing of tangible/intangible assets and services are provided by Section 482 and the related regulations. The current final regulations were published by the U.S. Treasury Department on July 8, 1994.

This section describes the key features of the regulatory framework of the transfer pricing regulations, including a review of the arm's-length standard. This discussion summarizes each transfer pricing method presented in the federal regulations related to the allocation of consolidated entity income between (1) tangible assets, (2) intangible assets, (3) intercompany debt, and (4) shared corporate services.

*"There are two primary considerations when selecting which of the allowed transfer pricing methods is the best method."*

### The Arm's-Length Standard

The transfer pricing regulations give the Internal Revenue Service broad authority to allocate income or expenses between related entities if it determines that such an allocation is necessary (1) to prevent the evasion of taxes or (2) to clearly reflect the income of the related entities. The regulations state that "[T]he purpose of Section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. . . ." (Regulation 1.482-1(a)(1)).

The regulations state that the standard applied to any related-party transaction is that of the same or similar transaction carried out by an independent taxpayer dealing at arm's-length with another independent taxpayer. "A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. . . ." (Regulation 1.482-1(b)(1)).

The basic concept underlying the Section 482 regulations arm's-length standard is the reliance on transactions that are independent or uncontrolled. In order to apply the arm's-length standard, taxpayers should identify (1) some transaction or transactions between independent, uncontrolled parties (2) where the price (or profitability) can be ascertained.

Once such transactions are identified, the "best method rule" relies on the standard of comparability to determine which transaction(s) provide the most reliable transfer price conclusion. In this regard, taxpayers should compare (1) the results of the subject related-party transaction to (2) the results of comparable transactions between uncontrolled parties under comparable circumstances.

### The Best Method Rule

The Section 482 regulations provide several methods for determining tangible/intangible asset intercompany transfer prices. And, the regulations require that the "best method" be used to determine the arm's-length pricing for each tangible/intangible asset intercompany transaction. The best method is defined as the method that produces the most reliable measure of an arm's-length price for the related party transaction, considering all relevant facts and circumstances.

There are two primary considerations when selecting which of the allowed transfer pricing methods is the best method.

The first consideration for determining the best method is the degree of comparability between (1) the subject controlled transaction and (2) the selected uncontrolled transaction. According to Regulation 1.482-1(d)(1), the five factors that should be considered when determining comparability are:

1. functions performed,
2. contractual terms,
3. risks borne,
4. economic conditions experienced, and
5. nature of the property or services.

The functional analysis procedures of a transfer price analysis are essential to assessing these five factors as they relate to the subject entity. A functional analysis involves finding and organizing facts about a business in terms of its functions, risks, and intangibles in order to identify how these characteristics are divided between the subject taxpayer business entities.

In the functional analysis, the analyst describes the value added activities undertaken by the taxpayer in order to identify independent comparable transactions that establish an arm's-length range of prices. Therefore, the functional analysis provides the factual foundation on which to apply the selected transfer pricing method—consistent with the Section 482 regulations arm's-length standard.

The second consideration for determining the best method is the quality of the data and assumptions used in the analysis. Again, there are three factors to consider in assessing the quality of the data and assumptions. These three factors are:

1. completeness and accuracy of data;
2. reliability of assumptions; and
3. sensitivity of the results to deficiencies in data and assumptions.

The regulations describe several methods for determining arm's-length tangible/intangible asset intercompany transfer prices. The best method rule does not suggest a priority in the application of the allowable methods. And, no allowable method is generally considered more reliable than another.

Indeed, there may be several possible methods that a taxpayer may use to establish an arm's-length benchmark for its intercompany transfer prices. The best method rule takes into account all facts and circumstances, including the above considerations, to determine which method provides the most reliable measure of an arm's-length result.

> *"Regulation 1.482-3(a) provides five methods of determining an arm's-length price for the related party transfer of tangible property."*

### Allowable Tangible Asset Transfer Pricing Methods

Regulation 1.482-3(a) provides five methods of determining an arm's-length price for the related-party transfer of tangible property:

1. the comparable uncontrolled price method,
2. the resale price method,
3. the cost plus method,
4. the comparable profits method, and
5. the profit split method.

The regulations also allow for methods other than these five methods, known as unspecified methods. The Regulation 1.482-1(c) best method rule is applied to select the most appropriate method. And, each allowable method should be applied in accordance with the general comparability rules outlined in Regulation 1.482-1.

### 1. The Comparable Uncontrolled Price Method (CUP)

The CUP method uses actual tangible asset transactions between unrelated parties to determine the arm's-length price for the transfer of tangible assets between related parties. This method analyzes whether the amount charged in the subject related-party (controlled) transaction is at arm's length by reference to the amounts charged in comparable uncontrolled transactions.

In this analysis, it is important that the selected CUP comparable transactions involve substantially the same products as the subject controlled transaction. This is because "similarity of products generally will have the greatest effect on comparability under this method. . . . If there are material product differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's-length result" (Regulation 1.482-3(b)(2)(ii)(A)).

### 2. The Resale Price Method

The resale price method can be used to determine the arm's-length price to be paid by the purchaser entity in the subject intercompany transaction when the purchaser entity, in turn, resells the subject tangible asset to unrelated parties.

According to Regulation 1.482-3(c)(1), this method ". . . evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of the function performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale."

### 3. The Cost Plus Method

The cost plus method determines the arm's-length price that the seller entity should receive in an intercompany transaction based on the markup on gross profit earned by sellers in comparable uncontrolled transactions. Specifically, Regulation 1.482-3(d)(1) states that the method ". . . evaluates whether the amount charged in a controlled transaction is arm's length 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 other production of goods that are sold to related parties."

The cost plus method focuses on the circumstances of the subject transaction/comparable transactions. This method does not require that the tangible asset being sold in the uncontrolled transactions be essentially identical to the tangible asset in the subject controlled transaction.

"[C]omparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers" (Regulation 1.482-3(d)(3)(ii)(A)).

## 4. The Comparable Profits Method (CPM)

The CPM determines an arm's-length price for the related-party transfer of tangible assets by reference to a measure of profitability of an unrelated company that engages in similar activities under similar circumstances. This method compares the profitability of either the related-party buyer or the related party seller, measured using a "profit level indicator" (PLI), to the profitability of the selected comparable company.

According to Regulation 1.482-5(c)(2)(ii), comparability under the CPM depends primarily on the related party's (1) functions performed, (2) resources employed, and (3) risks assumed. The degree of functional comparability required to obtain a reliable result using the CPM generally is less than the degree of functional comparability required under either (1) the resale price method or (2) the cost plus method.

*"The CPM determines an arm's-length price for the related-party transfer of tangible assets by reference to a measure of profitability of an unrelated company that engages in similar activities under similar circumstances."*

The first step in the CPM is to select either (1) the related-party buyer or (2) the related-party seller to be the "tested party." The tested party is the entity (1) for which profitability can be ascertained and (2) for which reliable data on comparables can be found. In general, the tested party is also the party that (1) has the least complex business operations and (2) employs the fewest intangible assets.

When the tested party (1) has complex activities and (2) uses significant intangible assets, it is usually difficult to identify uncontrolled companies that are sufficiently similar. The selected tested party should also be the related party with data that involve the fewest (and the smallest) and the most reliable adjustments.

The second step in the CPM is to select the appropriate PLI. The selection of the appropriate PLI depends on (1) the reliability of the available data and (2) the specific facts and circumstances of the taxpayer business.

The regulations specifically cite the following three basic profit level indicators:

1. the return on capital employed ratio,
2. the ratio of operating profit to sales (net margin), and
3. the ratio of gross profit to operating expenses.

Regulation 1.482-5(b)(4)(ii) imposes a greater standard of comparability when using the net margin ratio or the gross profit to operating expense ratio than the return on capital employed ratio: ". . . closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's-length result."

If there are differences between the tested party and the uncontrolled comparable company, Regulation 1.482-5(c)(2)(iv) provides that the comparable company financial data should be adjusted in order to take this differences into account.

The third and final step in the CPM is to establish an arm's-length price range based on the PLIs of the selected uncontrolled companies. If the tested party PLI falls within a reasonable range of price results, then its tangible asset intercompany prices are considered to be at arm's-length.

## 5. The Profit Split Method

The profit split method determines a tangible asset arm's-length transfer price based on the relative value of each related party's contribution to the combined profit or loss in a particular controlled transaction or set of controlled transactions.

According to Regulation 1.482-6(b), these related party contributions (1) are to reflect "the functions performed, risks assumed, and resources employed by each participant in the relevant business activity" and (2) should "correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity."

Regulation 1.482-6(c)(2)(i) describes the comparable-based profit split method. In this method, uncontrolled taxpayers' proportions of the combined operating profit in situations similar to the controlled transaction are used to allocate the related parties' combined operating profit.

Regulation 1.482-6(c)(3)(i) describes the residual profit split method. In this method, profit is first allocated to (1) routine functions, services, and intangible assets, and then to (2) profit not accounted for by the routine contributions. This allocation is based on the related parties' contributions to the total taxpayer residual profit.

## 6. Unspecified Methods

From the standpoint of the intercompany transfer price regulations, a method that has not been explicitly defined (that is, a method other than the CUP method, resale price method, cost plus method, CPM, CUT method, or the profit split method) can be applied if it provides the most reliable measure of an arm's-length return under the best method rule.

The use of an unspecified transfer price 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, and only enter into a particular transaction if none of the alternatives are preferable to it" (Regulation 1.482-3(e)(1)).

### Allowable Intangible Asset Transfer Pricing Methods

The Section 482 regulations list the following five categories of specific intangible assets that are subject to the allowable transfer pricing methods:

1. patents, inventions, formulas, processes, designs, patterns, or know-how;
2. copyrights and literary, musical, or artistic compositions;
3. trademarks, trade names, or brand names;
4. franchises, licenses, or contracts;
5. methods, programs, systems, procedures, campaigns, surveys, forecasts, estimates, customer lists, or technical data.

*"The arm's-length price for a transfer of intangible assets may be determined using four allowable methods."*

Regulation 1.482-4(b)(1) also provides that "other similar property" is encompassed within the definition of an intangible asset. An intangible asset is considered similar to these specific assets if it derives value from its intellectual content or other intangible qualities, not from its physical attributes.

The arm's-length price for a transfer of intangible assets may be determined using four allowable methods:

1. the CUT method,
2. the CPM,
3. the profit split method, or
4. unspecific methods.

As always, the taxpayer's selection of an intangible asset transfer price method is governed by the best method rule.

### 1. Comparable Uncontrolled Transaction Method

Taxpayers may rely on CUTs to establish an arm's-length price for the transfer of intangible assets. Under the CUT method, the arm's-length price for a related-party transfer of intangible assets is equal to the price charged or incurred in a comparable uncontrolled transaction (Regulation 1.482-4(c)(1)).

Although the CUT method is not given formal priority under the best method rule, the regulations note that it will generally provide the most direct and reliable arm's-length price—if (1) the comparable intangible asset is the same as the subject intangible asset and (2) the comparable intangible asset is transferred under sufficiently similar circumstances.

The CUT method may produce a single result that is the most reliable arm's-length price or a range of acceptable arm's-length prices.

The general standards of comparability govern the selection of a CUT. However, the regulations note that two comparability factors are particularly relevant to the use of the CUT method. First, the proposed comparable intangible asset should be the same as or comparable to the subject intangible asset. Second, comparability will depend on (1) the contractual terms of the transfer and (2) the economic conditions under which the transfer takes place (Regulation 1.482-4(c)(2)(iii)(A)).

The first factor concerns the nature and profitability of the transferred intangible asset. The standard is satisfied if: (1) the intangible assets are used in connection with similar products or processes within the same general industry or market and (2) they have similar profit potential.

The second factor—whether an uncontrolled transfer is made under "comparable circumstances"—is determined by considering a range of relevant factors.

### 2. Comparable Profits Method

The CPM determines the arm's-length price for a related party transfer of intangible assets by reference to objective measures of profitability (the PLI) derived from the financial data of unrelated parties. The unrelated parties should be engaged in similar business activities with other unrelated parties under comparable circumstances.

Because the CPM determines arm's-length income by reference to an approved measure of operating profit, it relies on a broader scope of data (beyond a specific uncontrolled transaction) to test a related party transfer.

Under the CPM, an appropriate PLI is (1) derived from the financial data of an uncontrolled comparable company and then (2) applied to the financial data of one of the related parties (the "tested party") (Regulation 1.482-5(b)(1)).

The tested party is typically the entity in the related party transaction (1) for which operating profit can be most readily verified with the least and most reliable adjustments and (2) for which reliable comparable companies can be identified. This aspect of the CPM strives for practicality as well as for comparability.

The tested party is typically the least complex related party. The ownership of intangible assets is important in determining the tested party. Generally, the least complex related party will not own valuable intangible assets that could distinguish it from the potential comparable companies (Regulation 1.482-5(b)(2)).

### 3. Profit Split Method

The profit split method tests the arm's-length nature of the allocation of combined operating profit (or loss) attributable to the related-party transactions. The profit split method focuses on the relative value of each related-party contribution to that profit (or loss). This method requires an examination of the most narrowly identifiable business activity of the taxpayer (1) for which data are available and (2) which includes the subject related-party transactions.

The profit split method measures the value of each related party's contribution to profit by assessing the (1) functions performed, (2) risks assumed, and (3) resources employed by each party (Regulation 1.482-6(b)).

This comparison attempts to achieve the same allocation of profit that would have occurred between unrelated parties engaged in the same business segment as the related parties. The profit allocated is not necessarily capped at the total taxpayer profit from that activity. Therefore, one related party may be allocated profit, while the other related party may be allocated loss.

> *"The profit split method focuses on the relative value of each related-party contribution to that profit (or loss)."*

The profit split method has long been used as a means of resolving related-party pricing disputes, especially in cases involving the transfer of intangible assets. The current regulations expressly recognize two specific types of profit splits: (1) the comparable profit split and (2) the residual profit split. However, other types of profit splits may qualify as an unspecified method.

#### a. Comparable Profit Split Method

The comparable profit split method looks beyond the allocation of profit made by the controlled taxpayer. This method allocates operating profit based on the comparable allocation of operating profits of unrelated taxpayers with (1) functions, (2) transactions, (3) markets, (4) risks, and (5) assets employed (especially intangible assets) similar to those of the controlled taxpayer (Regulation 1.482-6(c)(2)).

Therefore, the percentage of combined operating profit earned by the uncontrolled taxpayer acting at arm's length is used to allocate to each related party the operating profit (or loss) arising from the related-party transaction (Regulation 1.482-6(c)(2)(i).

Because the comparable profit split method is based on a comparison of operating profit, the comparable profit should closely reflect the similarity of the related party and unrelated party transactions in terms of the (1) resources employed (including both tangible and intangible assets), (2) risks assumed, and (3) functions performed by the related parties (Regulation 1.482-6(c)(2)(ii)).

#### b. Residual Profit Split Method

The second profit split method is the residual profit split method. This method is of particular significance to related-party transactions that generate above-market profits as a result of the exploitation of intangible assets. The residual profit split involves a two-step allocation process.

First, operating profit (or loss) is allocated to each related party in order to provide that party with a market return for its "routine" contributions to the business activity. The "routine" contributions are those similar to contributions made by unrelated taxpayers in comparable business activities, including the contributions of tangible property, services, and intangible assets that are typically owned by unrelated taxpayers.

The market return is determined by reference to the returns achieved by unrelated taxpayers engaged in similar activities.

Second, once the market return component for routine contributions is determined, any residual operating profit (or loss) is allocated to the controlled taxpayer based on the relative value of its contribution of nonroutine intangible assets. The residual income component reflects the profit attributable to the ownership and exploitation of nonroutine intangible assets.

Preferably, the value of the intangible asset contribution will be determined by reference to external market benchmarks reflecting the fair market value of the intangible assets.

Such external market benchmarks of intangible asset value, however, are difficult to find. Indeed, if they could be found, the taxpayer may be able to use the CUT or the CPM. Therefore, the regulations acknowledge that the residual profit split may be determined by reference to internal cost allocations.

### 4. Unspecified Methods

The current Section 482 regulations permit the use of methods not specifically listed—so-called unspecified methods—to evaluate related-party transactions, including transactions involving intangible assets (Regulation 1.482-4(d)).

An unspecified method may be similar to one of the specified methods, but with alterations that make it noncompliant with the express requirements of the specified method. In any event, an unspecified method cannot prevail unless it would be considered to be the best method in the specific circumstances.

## Recent IRS Proposed Regulations for Intercompany Services

On September 5, 2003, the Internal Revenue Service proposed regulations updating the intercompany transfer pricing rules for transactions involving intercompany services. The proposed regulations:

1. suggest certain changes regarding the recognition of income attributable to transferred intangible assets and
2. provide guidance to better coordinate the rules for intercompany services transactions with the rules for intercompany intangible asset transactions.

While regulations for related-party transactions involving tangible assets and intangible assets were finalized in the mid-1990s, the regulations for related-party services transactions went largely unchanged since 1968. The current regulations require that the intercompany price for controlled transactions involving related-party services be consistent with the arm's-length price. The arm's-length price depends on whether the related-party services transaction involves "duplicative," "beneficial," or "integral" services.

The current regulations state that the arm's-length price for nonintegral related-party services is equal to the "costs or deductions" incurred with respect to the services. This is true unless the subject taxpayer establishes that another price is more appropriate.

Effectively, this means that the arm's-length price for beneficial services can be equal to (1) cost or (2) cost plus an arm's-length markup. The regulations provide general guidance on (1) the definition of cost and (2) the appropriate allocation of indirect costs.

The arm's-length price for integral related-party services "shall not be deemed equal to cost" but rather "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts." Effectively, this means that integral related-party services should be charged at a price that includes a profit markup.

The current regulations provide no guidance regarding the methods to determine whether the transfer price for related-party services is consistent with an arm's-length price for unrelated-party services. Consequently, analysts have used the allowable methods for the transfers of tangible and intangible assets as unspecified methods for transactions involving related-party services.

With regard to income from intangible assets, the current regulations provide rules to identify which related-party entity should recognize the income. Under the rules, there can be multiple owners of a single intangible asset, including (1) the legal owner, (2) the taxpayer with the right to exploit the intangible asset, and (3) the taxpayer that contributes to the development or enhancement of the intangible asset.

## The Proposed Regulations Regarding Transferred Services

The proposed regulations will overhaul the way taxpayers document that their related-party services transactions are at arm's length. Two fundamental issues addressed by the proposed regulations are:

1. the definition of a controlled intercompany services transaction and
2. the allowable methods for analyzing related-party services transactions.

The proposed definition of a controlled services transaction is in line with international standards, particularly in the *Transfer Pricing Guidelines* established by the Organization for Economic Cooperation and Development (OECD). A controlled services transaction is defined as any activity by one controlled taxpayer that results in a "benefit" to one or more other controlled taxpayers.

Benefit is defined a direct, reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position. Further, an activity is considered to confer a benefit if an uncontrolled taxpayer in comparable circumstances (1) would be willing to pay an unrelated party to perform that activity or (2) would be willing to perform that activity for itself.

The proposed regulations also clarify those controlled services that (1) do not confer a benefit, and therefore (2) do not merit an arm's-length price. Consistent with the current regulations, the proposed regulations retain the concepts of (1) duplicative activities and (2) activities that produce only indirect or remote benefits. Both types of activities are not considered to provide a benefit to the recipient (unless the activities yield an identifiable, additional benefit).

The proposed regulations describe other activities that do not confer a benefit, including (1) shareholder activities (excluding day-to-day management) and (2) activities in which a member of the controlled group obtains a benefit solely due to its status as a member of that group.

Once an activity is determined to confer a benefit, it should carry an arm's-length price. The proposed regulations describe six allowable methods for analyzing the arm's-length nature of related-party transactions involving beneficial services.

Three of the six allowable methods—(1) the comparable uncontrolled services price method (CUSP), (2) the gross services margin method (GSM), and (3) the cost of services plus method (CSP)—are direct analogs of the methods allowed for the transfer price of tangible assets (tailored to transactions involving services).

Two of the six allowable methods—(1) the comparable profits method (CPM) and (2) the profit split methods (PSM)—already exist as specified methods for transferred tangible and intangible assets, respectively, and are applicable to transferred services.

The proposed regulations also outline a new allowable method, the simplified cost-based method (SCBM).

The SCBM is of particular interest to taxpayers and to analysts. This is because this method departs substantially from traditional intercompany transfer pricing methods. The SCBM is designed for low-margin services, such as back-office services. And, the SCBM is intended to replace the current treatment of nonintegral services.

Transactions should meet certain conditions and requirements in order to qualify for the SCBM. However, once the qualifying criteria are met, the SCBM is considered to be the best method.

A taxpayer should meet two conditions in order to use the SCBM: (1) the taxpayer should maintain adequate books and records detailing the determination and allocation of the total cost base and (2) subject to a de minimus exception, the taxpayer should have a written contract in place that outlines (a) the compensation for the transferred services and (b) the allocation of risks between the related parties.

Several types of transactions are not eligible for the SCBM. These ineligible transactions include related-party services:

1. similar to those provided to unrelated parties,
2. provided to a recipient that receives significant amounts of controlled services,
3. that involve the use of valuable or unique intangible assets, and
4. that are combined with other types of controlled transactions involving tangible or intangible assets.

In addition, several specific types of transactions are not eligible for the SCBM, including: manufacturing, production, extraction, construction, reselling, distribution, financial transactions, research and development, experimentation, engineering, and scientific services.

The SCBM is structured to limit the Internal Revenue Service ability to adjust the taxpayer's transfer price and taxable income. Under the SCBM, the Internal Revenue Service can adjust the price/income only if the arm's-length markup on total costs exceeds the markup charged by the taxpayer by at least a specified number of percentage points.

The "applicable number of percentage points" (1) is six if the amount charged by the taxpayer is total costs and (2) declines ratably to zero by one percentage point for every increase of two percentage points in the markup on total costs charged by the taxpayer. The proposed regulations illustrating this calculation are provided in Table 1 below.

Effectively, the markup applied by the taxpayer under the SCBM has to be significantly different from the arm's-length markup before the Internal Revenue Service can make an income/price adjustment. The Internal Revenue Service intends that the SCBM will reduce the compliance and administrative burdens with respect to low-margin services.

### The Proposed Regulations Regarding Intangible Asset Transfers

The Internal Revenue Service is concerned that the current regulations may be misapplied to reach "all or nothing" results based on a determination of intangible asset ownership. Therefore, the proposed regulations provide guidance on determining the ownership of intangible assets. In addition, the proposed regulations introduce the concept of "nonroutine" contributions to the development of an intangible asset.

The proposed regulations more effectively coordinate (1) the rules applicable to intercompany services transactions with (2) the rules for intercompany intangible asset transactions. In particular, the proposed regulations coordinate the rules for services transactions with the rules for intangible asset transfer profit split analyses.

This is accomplished by clarifying how income attributable to an intangible asset should be allocated among controlled taxpayers in accordance with each taxpayer's contribution to the development of that intangible asset.

Finally, the proposed regulations require that the arm's-length result for a services transaction that effects the transfer of intangible assets should be determined by an analysis using the rules for the transfer of intangible assets. If the services transaction impacts an intangible asset transfer transaction, then the taxpayer should analyze the services transactions twice: (1) once under the services transfer rules and (2) once under the intangible asset transfer rules.

## OECD Regulatory Framework

The OECD adopted the arm's-length standard as the principle to be applied to determine transfer prices in 1979. In the OECD *Final Guidelines*, the arm's-length principle remains the fundamental basis of transfer pricing between related parties. The *Final Guidelines* recognize that it is difficult to apply the

**Table 1**
**SCBM "Applicable Number of Percentage Points"**

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Markup charged by the taxpayer | 0% | 1% | 2% | 3% | 4% | 5% | 6% | 7% | 8% | 9% |
| Applicable number of percentage points | 6 | 5.5 | 5 | 4.5 | 4 | 3.5 | 3 | 2.5 | 2 | NA |
| Arm's-length markup necessary for an adjustment | 6% | 6.5% | 7% | 7.5% | 8% | 8.5% | 9% | 9.5% | 10% | 10% |

arm's-length principle in practice due to (1) the lack of appropriate comparables and (2) the lack of sufficient financial information for many appropriate comparables.

In comparison to the original 1979 guidelines, the *Final Guidelines* place greater emphasis and importance on comparability factors. And, these standards are used as the means to close the gap between transactional and profit-based methods. The greater the degree of comparability, the greater is the assurance that the results meet the arm's-length principle.

Comparability is to be assessed not only by product similarity, but also by (1) functions performed, (2) risks undertaken, (3) contractual terms, (4) economic circumstances, and (5) business strategies (i.e. market penetration).

The transfer pricing methods accepted by the OECD fall into two categories: (1) traditional transaction methods and (2) other methods. Traditional transaction methods are accepted in most countries and do not cause any controversy. The traditional transaction methods are the CUP, resale price and cost plus methods. Other methods are referred to by the OECD as "transactional profit methods." Transactional profit methods are defined as "methods that examine the profits that arise from particular transactions among associated enterprises."[1]

There are only two transactional profit methods that are both (1) consistent with the arm's-length principle and (2) accepted by the OECD. These two methods are (1) the profit split method and (2) the transaction net margin method (TNM). The CPM and modified cost plus/resale price method are accepted by the OECD only if they meet comparability guidelines.

The TNM method "examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction."[2] There are two significant requirements that must be met to use the TNM.

First, the selected comparables should meet strict standards of comparability that go beyond product and functional similarity. In fact, the OECD prescribes comparability adjustments to be made for factors that are unrelated to transfer pricing, such as (1) management efficiency, (2) cost of capital, and (3) phase of business cycle.

Second, the TNM can only be applied to particular transactions, not on a companywide basis. In obtaining the comparable net margin from independent companies, the net margin should exclude other dissimilar transactions as well as any controlled transactions of the company.

In addition to discussing the arm's-length principle and various transfer pricing methods, the OECD guidelines also discuss (1) transfer pricing documentation and (2) administrative approaches to avoiding/resolving transfer pricing disputes. The OECD discourages the use of harsh penalties. The OECD explains that severe penalties in one jurisdiction may provoke taxpayers to overstate taxable income in that jurisdiction, thereby understating taxable income in a different jurisdiction.

With respect to documentation, the OECD emphasizes the need for documentation and recommends that "consideration should be given to whether the transfer pricing is appropriate for tax purposes before the pricing is established."[3]

On the other hand, the OECD argues that taxing authorities should not impose compliance burdens that would (1) translate into disproportionately high costs to taxpayers and (2) require taxpayers to produce information for tax purposes they would not otherwise produce.

> *"The functional analysis provides the factual foundation for establishing a transfer price method consistent with the arm's-length standard."*

## Functional Analysis

The functional analysis provides the factual foundation for establishing a transfer price method consistent with the arm's-length standard. A controlled transaction meets the arm's-length standard if the results of the transaction are consistent with the results that would have been realized had the same transaction taken place between unrelated entities.

A functional analysis is a procedure for finding and organizing facts about a business in terms of its (1) functions, (2) risks, and (3) intangible assets. The functional analysis identifies how these characteristics are divided between (1) the subject related entities and (2) the subject related party transactions.

The functional analysis describes the value added activities undertaken by a taxpayer in order to identify comparable transactions that establish an arm's-length price range.

A functional analysis is important to the development of an arm's-length transfer price for the following reasons:

1. The functions undertaken by each related party typically correlate with (a) the risks borne and (b) the intangible assets assumed or developed.
2. The functions, risks, and intangible assets associated with a related party's operations usually have a significant effect on its profitability.
3. The functional analysis provides the information necessary to (a) characterize intercompany transactions and (b) identify uncontrolled transactions comparable to the related-party transactions.

For any given line of business or industry, the "normal" market returns to certain functions/factors of production are relatively predictable and measurable. The rates of return to other "intangible" assets (often including entrepreneurship) and risk-taking, however, are less easily determined.

If one party to an intercompany transaction has primarily measurable functions and factors, prices can be set to reward these functions and factors with "normal" returns. This procedure leaves the residual profit to the related party responsible for (1) developing intangible assets and (2) performing entrepreneurial and risk-taking functions.

By providing a description of the (1) functions and assets (tangible and intangible) and (2) their location within a consolidated corporate entity, a functional analysis provides the first step in evaluating the relative contribution to profit to the various related companies.

The functional analysis begins with a business overview. This overview has two primary purposes. The first purpose is to furnish a general understanding of the subject company by providing information on such topics as its history, products, customers, and strategic direction. The second purpose is to describe the industry in which the company operates. This industry review should provide an understanding of the critical success factors in the industry, the client's competitors, and the industry's major trends.

Following the business overview, the functional analysis investigates the functions assumed by the related parties in the specific related transactions. For this analysis, the functions are simply the activities that each entity to a particular transaction performs as a normal part of its operations.

Functions are generally divided into the following three categories:

1. Product and manufacturing functions, or those activities that impact the research, development, and manufacturing of a company's products.
2. Marketing, advertising, and sales and distribution functions, or those activities that impact the manner in which the company's products are marketed, advertised, sold and distributed.
3. General management functions, or those activities such as treasury management, development of information systems, etc. that are necessary to support the operations of the company.

The description of the functions is followed by a description of the important intangible assets used during the production and sales processes. Intangible assets include any nonmaterial assets developed or owned by the taxpayer, including but not limited to: trade secrets, patents, proprietary know-how, customer lists, trademarks, and distribution networks. The functional analysis should assess the contribution these intangible assets make to the taxpayer's profit.

The discussion of intangible assets is typically followed by a summary of the key business risks encountered by the related parties to the subject transaction. Business risks exist due to the possibility of events arising to the detriment of the business. A significant portion of the return earned by any company reflects the fact that the business is bearing risks of various kinds.

The functional analysis concludes with a characterization of each of the related entities in the context of the subject transaction(s) covered in the functional analysis. This functional analysis is repeated for each of the subject transactions covered in the intercompany transfer price study.

## Summary and Conclusion

Property owners subject to the unit valuation method often face the problem of allocating overall unit income/value between (1) taxable tangible assets and (2) exempt intangible assets. The Internal Revenue Service is also faced with the problem of allocating taxable income related to the intercompany transfer of tangible/intangible assets in the case of multinational corporations.

Accordingly, over the years, the U.S. Treasury promulgated detailed regulations for the determination of transfer prices for the arm's-length intercompany use of transferred tangible/intangible assets. The economic analysis methods allowed under these regulations allocate the total income of the multinational taxpayer based on the use of tangible/intangible assets transferred between domestic and foreign taxing jurisdictions.

These tangible/intangible asset transfer price methods have been developed/updated over decades and tested/interpreted in the federal courts. These tangible/intangible asset transfer price methods could be used to allocate taxpayer total unit income between taxable tangible assets and exempt intangible assets. Consistent with the conceptual framework of Section 482, the total taxpayer unit income could be allocated as if the tangible assets and intangible assets were owned by independent, arm's-length entities.

These Section 482 transfer pricing/income allocation methods may be more effective and more efficient than the current procedure. Using the current unit value allocation procedure, taxpayers and taxing authorities often argue over the allocation of the total unit value between the unit tangible assets and the unit intangible assets.

Notes:

1. OECD, *OECD Transfer Pricing Guidelines*, (Paris: OECD, 1995), par. 3.1.
2. Ibid., par. 3.26.
3. Ibid., par. 5.3.

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