

INTELLECTUAL PROPERTY INTERCOMPANY TRANSFER PRICE PLANNING CONSIDERATIONS

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A multinational corporation often has numerous strategic planning opportunities with regard to the ownership and operation of its intellectual property (IP). For example, the multinational corporation could develop and own the IP in one country and then use (operate) the IP in another country. In such instances, the multinational corporation should establish a reasonable intercompany transfer price related to the hypothetical license between the related party IP owner/licensor and the related party IP operator/licensee. This discussion summarizes the procedural guidance provided by the Internal Revenue Code Section 482 Regulations with regard to the calculation of a fair, arm's-length price for the intercompany transfer of IP between related-party controlled taxpayers.

INTRODUCTION

Multinational corporations generally have numerous strategic planning opportunities with regard to their intangible property. Intangible property is the federal taxation terminology for what financial advisers (and corporate executives) typically call intangible assets.

While intangible property can encompass the broad spectrum of intangible assets, this discussion will focus on the intercompany transfer price issues related to intellectual property (IP). And, for purposes of this discussion, we will focus on the four statutorily defined categories of IP: (1) patents, (2) trademarks, (3) copyrights, and (4) trade secrets.

Again, a multinational corporation typically has numerous corporate planning opportunities related to its IP. It can decide where to develop the IP. It can decide where to own the IP. It can decide where to use (i.e., operate) the IP. Based on the locations of IP ownership and IP operation, the multinational can decide where to inbound license the IP. And, the multinational can decide where to outbound license the IP.

Most importantly for purposes of this discussion, the multinational corporation can decide on the appropriate intercompany transfer price for the subject IP. The transfer price is the royalty that the related party IP owner charges to the related party IP operator for the use of the subject IP.

These strategic management decisions have organizational and legal implications for the subject multinational

corporation. These strategic management decisions may also have operational and strategic (e.g., market competition) implications for the multinational corporation.

However, if two or more national taxing jurisdictions are involved, these strategic management decisions will almost certainly have income tax implications for the multinational corporation. These taxation-related implications related to IP strategic planning decisions are the topic of this discussion.

The principal application of IP intercompany transfer price analysis relates to Internal Revenue Code Section 482 compliance. Section 482 governs the related-party intercompany transfer across international boundaries of property and services. For purposes of Section 482 compliance, a related-party exists when one company/taxpayer controls or participates in the policy decisions of another company/taxpayer.

A common example of related parties would be a parent corporation and a subsidiary corporation. For example, General Electric (GE) owns 80 percent of NBC Universal (NBC). Therefore, parent GE and subsidiary NBC are considered to be related parties.

However, the issue of Section 482 intercompany transfer pricing compliance specifically arises when (1) a domestic entity controls a foreign entity (or vice versa) and (2) there is a transfer of tangible property, intangible property, or services between the two entities. In such a situation, the price at which these goods or services are transferred between the domestic entity and the foreign entity will

affect the amount of taxable income recognized in each of the two taxing jurisdictions.

For purposes of our discussion of IP intercompany transfer pricing, we will assume that the parent corporation is located in one national taxing jurisdiction (e.g., the United States) and the controlled subsidiary is located in another national taxing jurisdiction (e.g., not the United States).

USING A PRO FORMA INCOME STATEMENT TO ILLUSTRATE THE SECTION 482 CONSIDERATIONS

Let’s assume our hypothetical multinational corporation is a U.S. parent corporation (“USPar”) with a wholly-owned foreign subsidiary (“ForSub”). Let’s also assume that the hypothetical multinational corporation is a pharmaceutical company.

In our example, let’s assume that USPar develops and owns the subject pharmaceutical compound IP. That IP may include the patent on the drug compound, the trademark on the drug product name, the copyright on the physician education and drug promotional material, and the trade secret on the proprietary drug manufacturing process.

In our example, USPar operates the IP in its US pharmaceutical manufacturing and distribution business. However, USPar also allows ForSub (let’s say ForSub is located in France) to use its IP. Therefore, ForSub will use the US-owned IP in its French pharmaceutical manufacturing and distribution business.

To illustrate how Section 482 influences the intercompany transfer price of intangible property (such as the USPar IP) between related parties, let’s assign hypothetical income data to our example with USPar and ForSub. We will create a simplified pro forma income statement for this hypothetical multinational corporation.

We will consider both (1) the consolidated results of operations for the consolidated multinational entity and (2) the national results of operations for both the (a) separate USPar entity and (b) the separate ForSub entity.

Based on this simplified pro forma income statement analysis, the Section 482 intercompany transfer price implications related to the subject IP should be obvious.

Let’s assume the following simplified results of operations data for our hypothetical multinational pharmaceutical corporation.

1. The combined revenue for the subject drug product is 100 million in US dollars—with \$75 million revenue from the US and \$25 million revenue from France.
2. The cost of goods sold (COGS) for the subject drug product is 62.5 percent of the product revenue; this drug product COGS is the same in the United States and in France.

3. The product selling, general, and administrative expense (SG&A) is 30 percent of the product revenue; this product SG&A expense is the same in the United States and in France.
4. Interest expense and other expense account for 0.6 percent of revenue in both countries.
5. The federal income tax rate in the United States is 40 percent.
6. The federal income tax rate in France is 10 percent.

Under the provisions of Section 482, ForSub (as the operator of the U.S.-owned subject IP) should enter into a license agreement with USPar (as the owner of the U.S.-owned subject IP). In other words, USPar should charge a royalty rate (or some other type of transfer price) to ForSub for a hypothetical license to compensate USPar for ForSub’s use of the USPar-owned IP.

Given the above illustrative results of operations assumptions, we have enough information to prepare a pro forma income statement for the two related-party entities (i.e., USPar and ForSub). In fact, we can prepare a pro forma income statement for the two entities at various assumed levels of IP license intercompany transfer price/royalty rates.

Figure 1 presents the simplified pro forma income statement format. We will use this pro forma income statement in this discussion to illustrate the impact of IP transfer prices on (1) income taxes and (2) net income.

Figure 1
Hypothetical Multinational Corporation
Simplified Pro Forma Income Statement

	Revenue
<u>minus</u>	<u>COGS</u>
equals	Gross profit
<u>minus</u>	<u>SG&A</u>
equals	Operating profit
<u>minus</u>	<u>Interest/other expense</u>
equals	Taxable income
<u>minus</u>	<u>Income tax expense</u>
equals	Net income

Notes:
 COGS = costs of goods sold
 SG&A = selling, general, and administrative expenses
 Taxable income represents revenue less expenses (i.e., COGS, SG&A, and Interest/other)
 Net income represents taxable income less income taxes

It is noteworthy that the IP license agreement between USPar and ForSub creates royalty income for USPar and royalty expense for ForSub. This is because ForSub will pay USPar a royalty payment for the license to use the USPar IP. The USPar royalty income is recorded as revenue. And, the ForSub royalty expense is recorded as COGS.

As a result of this IP license intercompany royalty payment from ForSub to USPar, USPar receives taxable income, while ForSub incurs a tax deductible expense. Of course, the amount of income taxes owed in each country depends on the income tax rate in each national jurisdiction.

With this set of simplified assumptions, we can create a pro forma income statement at various alternative IP license royalty rates. These IP license royalty rates represent the IP intercompany transfer price from the IP owner to the IP operator. These pro forma income statements, representing alternative assumed IP royalty rates, are presented in Tables 1 and 2.

In this simplified example, USPar is the IP licensor and ForSub is the IP licensee. Therefore, ForSub pays USPar for the licensed use of the USPar-owned IP. The IP license royalty payment is based on a percent of the drug product sales revenue in the licensee's country.

Now, let's use this IP-related management information to perform a simplified corporate planning analysis. Let's assume that USPar decides to transfer the ownership of the subject IP from the United States to ForSub in France. Now, after this property transfer, ForSub owns the subject IP and USPar uses the French-owned subject IP.

USPar and ForSub would still need to enter in a transfer pricing arrangement (i.e., a hypothetical IP license agreement) related to the use of the IP. However, after the transfer of the IP from the United States to France, USPar would have to pay a royalty to ForSub for the use of the now ForSub-owned IP.

EFFECT OF THE SELECTED IP ROYALTY RATE ON CONSOLIDATED NET INCOME

The results of Table 1 appear to contradict the results of Table 2 with respect to the relationship between (1) the IP royalty rate and (2) the consolidated net income. As the IP royalty rate increases, Table 1 indicates that the multinational corporation consolidated net income decreases. In contrast, Table 2 indicates that the multinational corporation consolidated net income increases as the IP royalty rate increases. However, these consolidated net income observations are to be expected.

In the Table 1 illustrative example, USPar is the owner of the subject IP and (therefore) the licensor of the IP. Therefore, ForSub will pay a royalty payment to USPar for the right to use the USPar-owned IP. Consequently, a higher

IP license royalty rate means that more royalty income flows away from a low tax rate jurisdiction and into a high tax rate jurisdiction. This IP royalty intercompany transfer payment would have an adverse effect on the consolidated net profit for the subject multinational corporation.

The Table 2 illustrative example reverses the ownership and (therefore) the license of the subject IP. In the Table 2 hypothetical example, ForSub becomes the owner of the subject IP and (therefore) the licensor of the subject IP.

In that case, USPar will pay a license royalty payment to ForSub for the use of the ForSub-owned IP. Consequently, a higher IP license royalty rate means that more royalty income flows away from a high tax rate jurisdiction and into a low tax rate jurisdiction.

As the licensee, USPar will treat the royalty payment as a COGS expense. This IP license royalty expense generates a greater consolidated after-tax income benefit (then the scenario where USPar was the licensor). This is because of the higher assumed U.S. income tax rate.

As one would expect, this after-tax income benefit reverses the economic effect of the IP license intercompany transfer price. And, it amplifies the economic effect of the IP royalty rate on the consolidated net income of the subject multinational corporation.

Tables 3 through 6 indicate that the source of the increased consolidated net income is the consolidated savings related to income taxes. In this illustrative example, the increased consolidated net income coincides with (1) a lower consolidated income tax expense paid to the United States and (2) a higher consolidated income tax expense paid to France.

Accordingly, how the subject multinational corporation sets its IP intercompany transfer price allows the subject multinational corporation to shift taxable income from the high tax rate jurisdiction to the low tax rate jurisdiction.

The net effect of that shift in taxable income from a high tax jurisdiction to a low tax jurisdiction is an increase in the consolidated after-tax net income of the subject multinational corporation. It should be no surprise, then, why the national tax authorities (e.g., the Internal Revenue Service in the United States) are interested in the intercompany transfer price practices of multinational taxpayers.

The Service does not particularly focus on the transfer prices agreed to in property transfers (e.g., IP licenses) between unrelated parties. This is because unrelated parties typically disregard the combined income tax effects of IP transfer price agreements.

Rather, unrelated parties focus on maximizing their own economic self-interests when they negotiate an IP transfer price agreement. Each party in an unrelated party IP transfer transaction has an adverse economic interest. That is, one unrelated party will want to receive a high IP transfer price/royalty rate while the other unrelated party will want to pay a low IP transfer price/royalty rate.

Table 1
Simplified IP Intercompany Transfer Price Illustration
Effect of IP License Royalty Rate on Consolidated Net Income
(in \$ million)

IP License Royalty Rate:	2% of Revenue		4% of Revenue		6% of Revenue	
	USPar	ForSub	USPar	ForSub	USPar	ForSub
Entity:						
Revenue	76.48	24.00	76.96	24.00	77.44	24.00
from product sales	76.00	24.00	76.00	24.00	76.00	24.00
from IP license	0.48		0.96		1.44	
COGS	47.50	15.48	47.50	15.96	47.50	16.44
from product production	47.50	15.00	47.50	15.00	47.50	15.00
from IP license		0.48		0.96		1.44
Gross Profit	28.98	8.52	29.46	8.04	29.94	7.56
SG&A	23.56	7.39	23.70	7.39	23.85	7.39
Operating Profit	5.42	1.13	5.76	0.65	6.09	0.17
Interest & Other Expense	0.46	0.14	0.46	0.14	0.46	0.14
Taxable Income	4.97	0.98	5.29	0.50	5.62	0.02
Income Taxes	1.99	0.10	2.12	0.05	2.25	0.00
Net Income	2.98	0.89	3.18	0.45	3.37	0.02
Consolidated Net Income		3.86		3.63		3.40

Note:
USPar is the IP licensor and ForSub is the IP licensee. Therefore, ForSub pays USPar for the licensed use of the USPar-owned IP. The IP license royalty payment is based on a percent of the drug product sales revenue in the licensee's country.

Table 2
Simplified IP Intercompany Transfer Price Illustration
Effect on Consolidated Net Income of Reversing the IP Licensor and the IP Licensee
(in \$ million)

IP License Royalty Rate:	2% of Revenue		4% of Revenue		6% of Revenue	
	USPar	ForSub	USPar	ForSub	USPar	ForSub
Entity:						
Revenue	76.00	25.52	76.00	27.04	76.00	28.56
from product sales	76.00	24.00	76.00	24.00	76.00	24.00
from IP license		1.52		3.04		4.56
COGS	49.02	15.00	50.54	15.00	52.06	15.00
from product production	47.50	15.00	47.50	15.00	47.50	15.00
from IP license	1.52		3.04		4.56	
Gross Profit	26.98	10.52	25.46	12.04	23.94	13.56
SG&A	23.41	7.86	23.41	8.33	23.41	8.80
Operating Profit	3.57	2.66	2.05	3.71	0.53	4.76
Interest & Other Expense	0.46	0.15	0.46	0.16	0.46	0.17
Taxable Income	3.12	2.51	1.60	3.55	0.08	4.59
Income Taxes	1.25	0.25	0.64	0.35	0.03	0.46
Net Income	1.87	2.26	0.96	3.19	0.05	4.13
Consolidated Net Income		4.13		4.15		4.18

Note:
USPar is now the IP licensee and ForSub is now the IP licensor. Therefore, USPar now pays ForSub for the use of the ForSub-owned IP. The IP license royalty rate is based on a percent of the drug product sales revenue in the licensee's country.

**Tables 3 Through 6
The Source of the Increase in Consolidated Net Income
(in \$ million)**

**Table 3
Intercompany IP License Illustrative Example
Consolidated Net Income
(in \$ million)**

	IP License Royalty Rate (as a Percent of Revenue)		
	2%	4%	6%
Licensor			
USPar	3.86	3.63	3.4
ForSub	4.13	4.15	4.18

**Table 4
Intercompany IP License Illustrative Example
Total Income Taxes Paid
(in \$ million)**

	IP License Royalty Rate (as a Percent of Revenue)		
	2%	4%	6%
Licensor			
USPar	2.08	2.17	2.25
ForSub	1.5	0.99	0.49

**Table 5
Intercompany IP License Illustrative Example
Income Tax Expense Paid to the US
(in \$ million)**

	IP License Royalty Rate (as a Percent of Revenue)		
	2%	4%	6%
Licensor			
USPar	1.99	2.12	2.25
ForSub	1.25	0.64	0.03

**Table 6
Intercompany IP License Illustrative Example
Income Tax Expense Paid to France
(in \$ million)**

	IP License Royalty Rate (as a Percent of Revenue)		
	2%	4%	6%
Licensor			
USPar	0.10	0.05	0.00
ForSub	0.25	0.35	0.46

Multinational corporations often encounter the issue (and the planning opportunity) related to IP intercompany transfers between related parties. In these instances, there are ample opportunities for IP intercompany transfer price opportunities for the purpose of legitimately minimizing the multinational corporation's consolidated income tax expense. These planning opportunities explain the motivation of the various national taxing authorities to monitor IP intercompany transfer prices between multinational controlled companies (i.e., related parties).

THE ARM'S-LENGTH STANDARD OF INTERCOMPANY TRANSFER PRICES

In order to assess the reasonableness of intercompany transfer pricing, the Internal Revenue Code provides for the arm's-length standard. The arm's-length standard is a requirement that the controlled party intercompany transfer price reflect a price that two unrelated parties would have negotiated.

According to Regulation Section ("Regulation") 1.482-1(b)(1), "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 (arm's-length result)."

METHODS OF CALCULATING AN ARM'S-LENGTH TRANSFER PRICE

Regulation 1.482-4(a) specifies three specific methods (and one unspecified method) for calculating an arm's-length intercompany transfer price related to intangible property (e.g., IP). "The arm's-length amount charged in a controlled transfer of intangible property must be determined under one of the four methods. . . ."

1. the comparable uncontrolled transaction (CUT) method
2. the comparable profits method (CPM)
3. the profit split method
4. the unspecified method

Next, we will describe the generally accepted procedures with respect to each of these Section 482 IP-related intercompany transfer price methods. First, however, it is noteworthy that the Section 482 Regulations require that the taxpayer select "one of the four methods" with regard to the calculation of the appropriate intercompany transfer price.

The synthesis of the royalty rate indications resulting from several transfer price methods is a common procedure

performed in many other types of IP economic analyses. Examples of these other (non-Section 482) types of IP royalty rate economic analyses include the following:

1. assessing the fairness of an unrelated party IP license agreement
2. calculating the appropriate royalty rate for an IP infringement dispute
3. calculating economic damages in an IP breach of contract or other commercial litigation.

In contrast, for Section 482 purposes, taxpayers (or analysts) should use only one intercompany transfer method—the best method—to determine the most appropriate IP royalty rate. Therefore, an understanding of each IP transfer price method is important in the selection of the best method for Section 482 compliance purposes.

The Comparable Uncontrolled Transaction (CUT) Method

Regulation 1.482-4(c) indicates:

The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of intangible property was arm's-length by reference to the amount charged in a comparable uncontrolled transaction.

Effectively, there are three principal procedures to the CUT method for calculating an IP intercompany transfer price:

1. Search for and select arm's-length, unrelated party sales or licenses of comparable IP.
2. Verify that the comparable IP property transactions were conducted under comparable circumstances.
3. Analyze the CUT data and select a subject IP-specific royalty rate from the empirical pricing data indicated by the uncontrolled IP transfer transactions.

Procedure 1: Search for and Select Transactions of Comparable Intangible Property

It is often difficult for an analyst to find uncontrolled sale or license transactions in sufficiently comparable IP. For example, in order for an inventor to receive a patent, the technology must be both novel and nonobvious. Therefore, even “comparable” patents must have a significant difference from the subject patent.

Trade secrets have a similar situation. In order to qualify as IP, the subject trade secret must be maintained as a secret. If a comparable trade secret was licensed, then the

license of that trade secret would have to be confidential. If the trade secret was adequately described in the subject license, then it could no longer be a secret.

The subject trademark and the CUT trademarks must be similar, of course. But, the CUT trademarks cannot be similar to the subject trademark enough to fool the public into misjudging the product source.

Of course, the Section 482 Regulations (i.e., Regulation 1.482-4(d)(2)) do not require that a CUT relate to identical intangible property, only to comparable intangible property. Regulation 1.482-4(c)(iii)(B)(1) defines a comparable intangible asset as one that (1) should be used with similar products or processes within the same general industry or market and (2) should have a similar profit potential.

Regardless of this procedural definition of comparability, the analyst's task of finding and selecting comparable IP sale or license transactions is often difficult.

Procedure 2: Confirm that the Intangible Property Was Transferred under Comparable Circumstances

The second analytical procedure, finding similar transactional circumstances, may also be difficult for the analyst to perform. There are numerous individual factors that affect the CUT sale or license price related to each IP transaction. And, Regulation 1.482-1(d)(1) requires the analyst's consideration of all factors that affect the CUT price.

Obviously, no list of comparable circumstances pricing factors can be comprehensive. However, there are eight pricing factors that are particularly relevant to the CUT method, according to Regulation 1.482-4(c)(iii)(B)(2).

These eight CUT “comparable circumstances” pricing factors are summarized as follows:

1. the terms of the CUT transfer, including the exploitation rights granted to the CUT intangible asset, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited
2. the stage of development of the CUT intangible asset (including, where appropriate, necessary governmental approvals, authorizations, or licenses) in the market in which the CUT intangible asset is to be used
3. rights to receive updates, revisions, or modifications of the CUT intangible asset
4. the uniqueness of the intangible property and the period for which it remains unique, including the degree and duration of protection afforded to the intangible property under the laws of the relevant countries
5. the duration of the CUT license, contract, or other agreement, and any termination or renegotiation rights
6. any economic and product liability risks to be assumed by the intangible property transferee

7. the existence and extent of any collateral transactions or ongoing business relationships between the intangible property transferee and transferor
8. the functions to be performed by the intangible property transferor and transferee, including any ancillary or subsidiary services

Regulation 1.482-1(d)(1) provides a list of five factors that are applicable to the analysis of comparability under Section 482. This list of the Regulation 1.482-1(d)(1) comparability factors is included in Exhibit 1.

Regulation 1.482-1(d)(3) provides a supplemental list of comparability considerations with regard to two of the five factors: (1) functional analysis and (2) contractual terms. These two factors are particularly relevant to the analysis of an IP intercompany transfer price. The primary portion of the Regulation 1.482-1(d)(3) discussion is presented in Exhibit 2.

Procedure 3: Select a Subject IP-Specific Royalty Rate

The CUT IP license royalty rates are not always publicly disclosed. When the IP license royalty rates are disclosed, they are often disclosed in an SEC filing, a court document surrounding litigation, or a published news source. Mining these publications for IP license royalty rate information, however, can be like searching for a needle in a haystack.

Accordingly, analysts often rely on publicly available IP license royalty rate data collection services (such as RoyaltySource) and periodic publications (such as *Licensing Royalty Rates* by Battersby and Grimes). These IP license royalty rate data resources consolidate many data sources into one large IP license database.

IP CUT Method Transfer Price Guidance from the Section 482 Regulations

The Section 482 Regulations present four examples to illustrate the application of the CUT method for calculating an IP intercompany transfer price. We will reproduce these four illustrative examples from the Regulations here.

The first Regulations example presents an idealized application of the CUT method. The other three Regulations examples indicate procedures for applying the CUT method under less than perfect circumstances.

Section 482 Regulations Illustrative Example No. 1

USpharm, a U.S. pharmaceutical company, develops a new drug Z. Drug Z is a safe and effective treatment for the disease “zeezee.” USpharm has obtained patents covering drug Z in the United States and in various foreign countries.

USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in various foreign countries.

USpharm licenses its subsidiary in country X to Xpharm, to produce and sell drug Z in country X. At the same time, USpharm licenses to an unrelated company, Ydrug, to produce and sell drug Z in country Y, a neighboring country. Prior to licensing the drug, USpharm had obtained patent protection and regulatory approvals in both countries. And, both countries provide similar levels of protection for IP rights.

Country X and country Y are similar countries in terms of population, per capita income, and the incidence of the disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, the costs of producing and marketing drug Z in each country are expected to be approximately the same.

USpharm and Xpharm establish terms for the intercompany IP license of drug Z that are identical in every material respect, including the IP royalty rate, to the terms established between USpharm and Ydrug.

In this case, the Service determines that the IP royalty rate established in the Ydrug license agreement is a reliable measure of the arm’s-length royalty rate for the Xpharm IP license agreement.

Section 482 Regulations Illustrative Example No. 2

The facts are the same as in Illustrative Example No. 1, except that the incidence of the disease zeezee in country Y is much higher than in country X. In this case, the profit potential from exploitation of the right to make and sell the drug Z is likely to be much higher in country Y than it is in country X.

Consequently, the Ydrug IP license agreement is unlikely to provide a reliable measure of the arm’s-length IP royalty rate for the Xpharm IP license.

Section 482 Regulations Illustrative Example No. 3

FP is a foreign company that designs, manufactures, and sells industrial equipment. FP has developed proprietary components that are incorporated in its products. These components are important in the operation of the FP equipment and some of them have distinctive features.

However, other companies produce similar components. And, none of these components by itself accounts for a substantial part of the value of the FP products.

FP licenses to its U.S. subsidiary, USSub, the exclusive North American rights to use the patented technology for producing component X. Component X is a heat exchanger used for cooling operating mechanisms in industrial equipment. Component X incorporates proven technology that

makes it somewhat more efficient than the heat exchangers commonly used in industrial equipment. FP also agrees to provide technical support to help adapt component X to the USSub products and to assist with initial production.

Under the terms of the IP license agreement, USSub pays FP a royalty equal to 3 percent of sales of USSub equipment incorporating component X.

FP does not license any unrelated parties to use component X, but many similar components are transferred between uncontrolled taxpayers. Consequently, the Service decides to apply the CUT method to evaluate whether the 3 percent royalty for component X is an arm's-length IP royalty.

The Service uses a database of company documents filed with the SEC to identify potentially comparable license agreements between uncontrolled taxpayers that are on file with the SEC. The Service identifies 40 license agreements that were entered into in the same year or in the prior or following year, as the controlled transfer.

These 40 license agreements relate to transfers of technology associated with industrial equipment that has similar applications to the USSub products. A further review of these uncontrolled license agreements indicates that 25 of the licenses involved components that have a similar level of technical sophistication as component X and could be expected to play a similar role in contributing to the total value of the final product.

The Service (1) makes a detailed review of the terms of each of the 25 uncontrolled license agreements and (2) finds that 15 of the uncontrolled license agreements are similar to the controlled agreement in that they all involve:

1. the transfer of exclusive rights for the North American market,
2. products for which the market could be expected to be of a similar size to the market for the products into which USSub incorporates component X,
3. the transfer of patented technology,
4. continuing technical support,
5. access to technical improvements,
6. technology of a similar age, and
7. a similar duration of the agreement.

The Service concludes that these 15 intangible assets have similar profit potential to the component X technology. That conclusion is based on (1) the above seven factors and (2) the fact that none of the components to which the IP license agreements relate accounts for a substantial part of the value of the final products.

The 15 selected CUT IP license agreements include the royalty rates presented in Table 7:

Table 7
CUT Method Regulations Illustrative Example 3
CUT IP License Agreements

Selected CUT IP License Agreement	CUT License IP Royalty Rate (as a percent of revenue)
1	1.0
2	1.0
3	1.25
4	1.25
5	1.5
6	1.5
7	1.75
8	2.0
9	2.0
10	2.0
11	2.25
12	2.5
13	2.5
14	2.75
15	3.0

Although the uncontrolled comparable IP licenses are clearly similar to the controlled IP transaction, it is likely that unidentified material differences exist between (1) the uncontrolled comparables and (2) the controlled transaction. Therefore, an appropriate statistical technique should be used to establish the arm's-length range. In this case, the Service uses the interquartile range to determine the arm's-length range.

Therefore, the arm's-length range covers IP license royalty rates ranging from 1.25 to 2.5 percent. And, an adjustment is warranted to the 3 percent royalty charged in the controlled transfer. The Service determines that the appropriate adjustment corresponds to a reduction in the IP royalty rate to 2.0 percent, which is the median of the comparable uncontrolled transactions.

Section 482 Regulations Illustrative Example No. 4

USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit. Nosplit is useful in treating migraine headaches and produces no significant side effects. Nosplit replaces another drug, Lessplit, that USdrug had previously produced and marketed as a treatment for migraine headaches.

A number of other drugs for treating migraine headaches are already on the market. However, Nosplit is expected (1) to rapidly dominate the worldwide market for such

treatments and (2) to command a premium price since all other treatments produce side effects.

Therefore, USdrug management projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

USdrug licenses to its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit in the European market. In setting the royalty rate for this IP license, USdrug considers the royalty that it established previously when it licensed the right to produce and market Lessplit in the European market to an unrelated European pharmaceutical company.

In many respects, the two IP license agreements are closely comparable. The drugs were licensed at the same stage in their development, and the license agreements conveyed identical rights to the licensees. Moreover, there appear to have been no significant changes in the European market for migraine headache treatments since Lessplit was licensed.

However, at the time that Lessplit was licensed, there were several other similar drugs already on the market to which Lessplit was not in all cases superior. Consequently, the projected and actual Lessplit profits were substantially less than the projected Nosplit profits.

Therefore, USdrug management concludes that the profit potential of Lessplit is not similar to the profit potential of Nosplit. And, the Lessplit IP license agreement consequently is not a CUT for IP transfer pricing purposes, in spite of the other indicia of comparability between the two intangible assets.

The Comparable Profits Method (CPM)

Regulation 1.482-5(a) states:

The comparable profits method evaluates whether the amount charged in a controlled transaction is arm’s-length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

Effectively, there are four procedures to the application of the CPM for calculating an IP intercompany transfer price:

1. Select one of the companies in the IP transfer transaction; this company is called the “tested party.”
2. Identify an uncontrolled company that is comparable to the tested party.
3. Match the tested party’s operating profits to that of the comparable uncontrolled company, by applying a profit level indicator from the comparable, uncontrolled company to the tested party.

4. Calculate the IP intercompany transfer price that produces this level of operating profit.

Unlike the CUT method, the CPM method does not require the analysis of comparable IP sale or license transactions. Rather, the CPM method seeks to use profit level indicators of comparable, uncontrolled companies to set a controlled company’s level of operating profit. In other words, the CUT method focuses on comparable sale or license transactions. The CPM focuses on comparable public companies.

Because profit level data related to publicly traded comparable uncontrolled companies are generally available, the CPM does not suffer the same data constraint obstacles as the CUT method. Consequently, it is often more practical for the analyst to use the CPM than the CUT method to establish an appropriate IP intercompany royalty rate.

Procedure 1: Select the Tested Party

The application of the CPM method first involves isolating one of the related parties. This party is known as the “tested party.” To achieve the objective of the CPM method, Regulation 1.482-5(b)(2)(i) explains:

[T]he tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. . . .

Frequently, the selected tested party is the least complex company among the related parties. Accordingly, the tested party may be relatively easy to identify. However, either related party entity could serve as the tested party.

Procedure 2: Identify a Comparable Uncontrolled Company

After selecting the tested party, the analyst should identify and select comparable uncontrolled companies. In practice, this is the most difficult procedure in the application of the CPM method. Nonetheless, this procedure may be considerably easier than searching for CUT pricing data.

The rules for comparability outlined in Regulation 1.482-1(d) also apply to the CPM method. Again, these comparability criteria are presented in Exhibits 1 and 2.

According to Regulation 1.482-1(d)(2): [T]he degree of comparability between the tested party and the

uncontrolled taxpayer depends upon all the relevant facts and circumstances. . . .”

Adjustments for material differences between the uncontrolled companies and the tested party are appropriate. This is because unadjusted industry averages alone cannot establish an arm’s-length result.

Procedure 3: Calculate the Appropriate Profit Level Indicator (PLI)

In this procedure, the analyst will apply a profit level indicator (PLI) from the comparable uncontrolled companies to the tested party. In this procedure, the analyst will also calculate an arm’s-length range of PLIs.

A PLI measures profits in terms of either:

1. resources employed or
2. costs incurred.

The three common CPM profit level indicators are:

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

Another PLI may be used insofar as it provides a reliable measure of the income that the tested party would have earned had it negotiated with the controlled taxpayer at arm’s length.

Selecting the appropriate PLI is an important procedure. This is because the PLI should be based on producing a reliable measure of income. For intercompany transfer pricing purposes, the term “income” refers to “routine returns.” A routine return is generated solely from the functions a company performs, the risks a company assumes, and the assets a company employs.

If the subject company generates residual profits (i.e., profit above a routine return), then another transfer price method may be more appropriate. This is because the CPM method assumes that the profits for companies in the same industry, facing the same economic conditions, will tend to be equal over time.

The PLI quantifies the relationship between profit and a reference that comes from either (1) the balance sheet or (2) the income statement. If the subject entity uses significant assets in its operations, then it may be appropriate to use a balance sheet reference, such as capital employed. An income statement reference, such as revenue or operating costs, may be more appropriate for an entity that does not employ significant assets in its operations.

Next, we will discuss the three PLIs specified in the Section 482 Regulations. Whether a particular PLI is

appropriate to the subject analysis depends on several factors, including the reliability of the available data with respect to the uncontrolled companies. Consequently, there are several factors that should be considered by the analyst in the selection of the most appropriate PLI.

Rate of Return on Capital Employed (ROCE)

Let’s consider a perfectly competitive market, such as the grain market. Let’s assume that grain producers can sell all the grain they can produce at the market price. Therefore, a grain producer’s amount of operating profit depends on the amount of grain that it produces.

The amount of grain the producer can produce depends on its machinery, seed, fertilizer, and other capital investments. Consequently, the grain producer’s operating profits should be proportional to the level of capital investments.

Regulation 1.482-1(b)(4)(i) defines the rate of return on capital employed (ROCE) as the ratio of operating profit to operating assets. ROCE is an appropriate profit indicator when operating assets correlate with operating profits.

For example, this would be the case with a professional eBay trader, who has no fixed assets other than a computer. Therefore, the trader’s profits depend more on the nature of the item sold than on the age of the computer used to connect to eBay.

ROCE is also a less appropriate profit indicator (1) when the age and condition of the assets differ between tested party and comparable or (2) when the asset usage is substantially different for other companies operating in the same industry.

Back to the grain producer example, the use of the ROCE of a commercial farmer to predict the profits of an Amish farmer will probably not produce reliable results.

This is one additional complication with the ROCE measure of a PLI. This relates to the fact that the ROCE is derived from balance sheet data.

The balance sheet basically reflects the historical cost of a taxpayer’s asset. The historical cost of the taxpayer’s asset may be much less than the current value of that asset. Consequently, Regulation 1.482-5(b)(4)(i) indicates: “difficulties in properly valuing operating assets will diminish the reliability of this profit level indicator.”

To deal with this issue, many analysts calculate ROCE as total assets minus intangible assets minus investments in subsidiaries minus excess cash and equivalents. The validity of this ROCE formula varies by company and by industry.

Whatever measurement of ROCE the analyst uses, the analyst should make sure that he or she is consistent throughout the transfer price analysis. For example, if intangible assets are removed from ROCE, any intangible asset-related expense should also be removed from the operating profit used to calculate ROCE.

Because ROCE is most appropriate for companies with significant tangible assets that play a substantial role in generating operating profit, the ROCE measure is generally used for manufacturing companies. When the testing companies do not employ a significant amount of tangible assets, then a PLI derived from income statement data may be more appropriate.

The Berry Ratio

Let's return to the example of the eBay online re-seller. If ROCE is not an appropriate PLI, then let's consider an alternative PLI measure.

It is noteworthy that the PLI should properly reflect income. Therefore, the PLI should reference the source of income. With the eBay trader, references to the balance sheet are not appropriate. This is because the profits do not correlate with the age of the computer, the size of the office, or any other operating assets. Instead, the trader's income is based on the price markup of the items sold.

If the trader sells computer parts online, his or her success depends on the ability to sell the parts for more than the component part purchase price. Consequently, a PLI that references operating expenses may better estimate the profits of a trader or distributor than would the ROCE.

One such PLI is the Berry Ratio. The Berry Ratio is the ratio of gross profit to operating expenses.

If the gross margins approximate the company's total revenue available to a distributor, and if the operating expenses approximate the total expenses of the company, then the Berry Ratio captures the distributor's markup.

Consequently, the Berry Ratio is a good indicator of income for a trader or distributor. This is because a distributor's income is based on the product price markup.

Of course, not all distributors are candidates for the Berry Ratio PLI. Obviously, if the relationship between operating expenses and gross profit is tenuous, then the reliability of the Berry Ratio is questionable. This issue would occur when operating expenses do not reflect all of the value that the distributor added.

For example, if a distributor buys computer hard drives in bulk and sell them individually online, then the cost of one hard drive represents the distributor's entire contribution to the product.

However, let's assume that the distributor buys many computer parts in bulk, builds several working computers, and sells those functional computers online. Then, the costs of the hard drives no longer reflect the distributor's contribution to the product.

Because the Berry Ratio only measures the price markup on operating expenses, it does not include the additional return earned by the distributor for assembling the parts into a computer.

In addition, the Berry Ratio may not accurately reflect income where a distributor or service provider has extremely low operating expenses relative to revenue. For example, it would be inappropriate to use a child's lemonade stand as a comparable for a local coffee shop. This is because the child's Berry Ratio is extremely high since the child incurs very little operating expense.

This example underscores one significant difference between the ROCE measure and the Berry Ratio. The ROCE inherently measures the level of investment and risk of a company, whereas the Berry Ratio does not.

Consequently, the comparability between the tested party and the comparable company necessary for the Berry Ratio to accurately predict operating profit is greater than with the ROCE. As a general rule, comparable companies with similar SG&A-to-revenue ratios to the tested party are candidates for the Berry Ratio.

Limitations on the Application of the CPM

The CPM transfer price method has two significant application limitations.

First, the CPM cannot be used when the operations of related companies are intertwined to such an extent that the analyst cannot reliably measure each party's contribution to the transaction. When the tested party is not well defined, a reliable comparable company is difficult to find.

Second, when the tested party uses valuable, non-routine intangible assets, then the CPM may be difficult to apply.

Valuable, nonroutine intangible assets are assets that most or all other companies do not have. However, non-routine intangible assets give the intangible asset owner a competitive advantage. One example of a valuable, non-routine intangible asset is a trade secret that results in a more efficient process to produce methanol.

If a tested party uses valuable, nonroutine intangible assets, then it may be difficult to identify a comparable company. It is unlikely that the analyst will uncover such intangible assets if used by a comparable, but these extraneous data points should be eliminated with the interquartile range.

IP CPM Transfer Price Guidance from the Section 482 Regulations

The Regulations present six examples to illustrate the application of the CPM for calculating an intercompany transfer price. Unlike the CUT method, the CPM method applies to the intercompany transfer price of both tangible assets and intangible assets.

Therefore, the Regulations present illustrative examples for the application of the CPM method to both types of assets.

We will include each of the Section 482 Regulations examples. This is because each example may be helpful to the analyst in developing an understanding of the CPM method.

Section 482 Regulations Illustrative Example No. 1

This example illustrates the transfer of tangible property resulting in no adjustment by the Service. FP is a publicly traded foreign corporation with a U.S. subsidiary, USSub. FP is under audit for its 2006 taxable year.

FP manufactures a consumer product for worldwide distribution. USSub imports the assembled product and distributes it within the United States at the wholesale level under the FP name.

FP does not allow uncontrolled taxpayers to distribute its product. Similar products are produced by other companies, but none of those products is sold to uncontrolled taxpayers or to uncontrolled distributors.

Based on all the facts and circumstances, the Service determines that the comparable profits method will provide the most reliable measure of an arm’s-length transfer price. USSub is selected as the tested party. This is because USSub engages in activities that are less complex than those undertaken by FP.

There are data from a number of independent operators of wholesale distribution businesses. These potential comparable companies are further narrowed to select companies in the same industry segment that perform similar functions and bear similar risks to USSub.

An analysis of the information available on these taxpayers indicates that the ratio of operating profit to sales is the most appropriate profit level indicator. And, this ratio is relatively stable where at least three years are included in the average.

For the taxable years 2004 through 2006, USSub reports the results of operations summarized in Table 8:

**Table 8
Regulations Illustrative Example No. 1
USSub Results of Operations**

USSub Results of Operations	2004	2005	2006	Three-Year Average
Revenue	\$500,000	\$560,000	\$500,000	\$520,000
Cost of Goods Sold	393,000	412,400	400,000	401,800
Operating Expenses	80,000	110,000	104,600	98,200
Operating Profit	27,000	37,600	(4,600)	20,000

After adjustments have been made to account for identified material differences between USSub and the uncontrolled distributors, the average ratio of operating profit to sales is calculated for each of the selected uncontrolled distributors.

Applying each uncontrolled distributor operating margin ratio to USSub would lead to the comparable operating profit (COP) for USSub presented in Table 9.

**Table 9
Regulations Illustrative Example No. 1
Comparable Operating Profit**

Selected Uncontrolled Distributor	Operating Profit to Revenue Margin (percent)	USSub COP
A	1.7	\$8,840
B	3.1	16,120
C	3.8	19,760
D	4.5	23,400
E	4.7	24,440
F	4.8	24,960
G	4.9	25,480
H	6.7	34,840
I	9.9	51,480
J	10.5	54,600

The USSub COP data are not sufficiently complete to conclude that it is likely that all material differences between USSub and the uncontrolled distributors have been identified. Therefore, an arm’s-length range can only be established pursuant to Regulation 1.482- 1(e)(2)(iii)(B).

The Service measures the arm’s-length range by the interquartile range of results, which consists of the COP results ranging from \$19,760 to \$34,840.

Although the USSub operating income for 2006 indicates a loss of \$4,600, the Service determines that no allocation should be made. This is because the USSub average reported operating profit of \$20,000 is within this range.

Section 482 Regulations Illustrative Example No. 2

Regulations illustrative example no. 2 illustrates the transfer of tangible property resulting in a price adjustment by the Service.

The facts of illustrative example no. 3 are mostly the same as the facts in the above-presented illustrative example no. 1. The one difference in the illustrative example no. 3 fact set is that USSub reports the income and expenses presented in Table 10.

Table 10
Regulations Illustrative Example No. 2
USSub Results of Operations

USSub Results of Operations	2004	2005	2006	Three-Year Average
Revenue	\$500,000	\$560,000	\$500,000	\$520,000
Cost of				
Goods Sold	370,000	460,000	400,000	410,000
Operating Expenses	110,000	110,000	110,000	110,000
Operating Profit	20,000	(10,000)	(10,000)	0

The interquartile range of comparable operating profits remains the same as derived in the illustrative example no. 1: \$19,760 to \$34,840. The USSub average operating profit for the years 2004 through 2006 (\$0) falls outside of this range. Therefore, the Service determines that an allocation may be appropriate.

To determine the amount, if any, of the allocation, the Service compares the USSub reported operating profit for 2006 to comparable operating profits derived from the uncontrolled distributors' results for 2006.

The ratio of operating profit to sales in 2006 is calculated for each of the uncontrolled comparables. The operating profit margin for each uncontrolled distribution applied to the USSub 2006 revenue in order to derive the results presented in Table 11.

Table 11 ranks the selected uncontrolled distributors from the lowest operating profit margin (i.e., 0.5%) to the highest operating profit margin (7.4%).

Table 11
Regulations Illustrative Example No. 2
Comparable Operating Profit

Selected Uncontrolled Distributor	Operating Profit to Revenue Margin (percent)	USSub COP
C	0.5	\$2,500
D	1.5	7,500
E	2.0	10,000
A	1.6	13,000
F	2.8	14,000
B	2.9	14,500
J	3.0	15,000
I	4.4	22,000
H	6.9	34,500
G	7.4	37,000

Based on these results, the median of the comparable operating profits for 2006 is \$14,250. Therefore, the USSub income for 2006 is increased by \$24,250. The \$24,250 amount is the difference between (1) the USSub reported operating profit for 2006 and (2) the median of the comparable operating profits for 2006.

Section 482 Regulations Illustrative Example No. 3

Regulations illustrative example no. 3 illustrates a multiple year CPM analysis. The facts are the same as in illustrative example no. 2.

In addition, the Service examines the taxpayer's results for the 2007 taxable year. As in illustrative example no. 2, the Service increases the USSub income for the 2006 taxable year by \$24,250.

The results for the 2007 taxable year, together with the 2005 and 2006 taxable years, are presented in Table 12.

Table 12
Regulations Illustrative Example No. 3
USSub Results of Operations

USSub Results of Operations	2005	2006	2007	Three-Year Average
Revenue	\$560,000	\$500,000	\$530,000	\$530,000
Cost of				
Goods Sold	460,000	400,000	430,000	430,000
Operating Expenses	110,000	110,000	110,000	110,000
Operating Profit	(10,000)	(10,000)	(10,000)	(10,000)

The interquartile range of comparable operating profits, based on average results from the uncontrolled comparables and average sales for USSub for the years 2005 through 2007, ranges from \$15,500 to \$30,000.

In determining whether an allocation for the 2007 taxable year may be made, the Service compares (1) the USSub average reported operating profit for the years 2005 through 2007 to (2) the interquartile range of average comparable operating profits over this period.

The USSub average reported operating profit is determined without regard to the adjustment made with respect to the 2006 taxable year. See Regulation 1.482-1(f)(2)(iii)(D).

Therefore, the USSub average reported operating profit for the years 2005 through 2007 is (\$10,000). Because this amount of income falls outside the interquartile range, the Service determines that an allocation may be appropriate.

To determine the amount, if any, of the allocation for the 2007 taxable year, the Service compares the USSub reported operating profit for 2007 to the median of the comparable company operating profits derived from the uncontrolled distributors' results for 2007.

The median of the comparable company operating profits derived from the comparable uncontrolled company results for the 2007 taxable year is \$12,000.

Based on this comparison, the Service increases the USSub 2007 taxable income by \$22,000. This \$22,000 amount is the difference between (1) the median of the comparable company operating profits for the 2007 taxable year and (2) the USSub reported operating profit of (\$10,000) for the 2007 taxable year.

Section 482 Regulations Illustrative Example No. 4

Regulations illustrative example no. 4 analyzes the inter-company transfer of intangible assets to a related-party offshore manufacturer. DevCo is a U.S. developer, producer and marketer of widgets.

DevCo develops a new "high tech widget" (HTW) that is manufactured by its foreign subsidiary ManuCo. ManuCo is located in Country H. ManuCo sells the HTW to MarkCo (a U.S. subsidiary of DevCo) for distribution and marketing in the United States.

The DevCo 2006 taxable year is under audit. And, the Service examines whether the IP royalty rate of 5 percent paid by ManuCo to DevCo is an arm's-length transfer price for the HTW technology IP.

Based on all the facts and circumstances, the Service determines that the comparable profits method (CPM) will provide the most reliable measure of an arm's-length IP transfer price.

ManuCo is selected as the tested party. This is because ManuCo engages in relatively routine manufacturing activities. In contrast, DevCo engages in a variety of complex activities using unique and valuable intangible assets.

Finally, because ManuCo engages in manufacturing activities, it is determined that the ratio of operating profit to operating assets is an appropriate profit level indicator.

Uncontrolled taxpayers performing similar functions cannot be found in country H. It is determined that the data available in countries M and N provide the best match of companies: (1) in a similar market, (2) performing similar functions, and (3) bearing similar risks.

Such uncontrolled comparable company data are sufficiently complete (1) to identify many of the material differences between ManuCo and the uncontrolled comparables, and (2) to make adjustments to account for such differences.

However, the comparable uncontrolled company data are not sufficiently complete so that it is likely that no

material differences remain. In particular, the differences in geographic markets may have materially affected the results of the various companies.

In a separate analysis, it is determined that the price that ManuCo charged to MarkCo for the HTW product is an arm's-length transfer price under Regulation 1.482-3(b). Therefore, the ManuCo financial data derived from its sales to MarkCo are reliable.

The ManuCo financial data from 2004-2006 are presented in Table 13.

**Table 13
Regulations Illustrative Example No. 4
ManuCo Results of Operations**

ManuCo Results of Operations	2004	2005	2006	Three-Year Average
Assets	\$24,000	\$25,000	\$26,000	\$25,000
Sales to MarkCo	25,000	30,000	35,000	30,000
Cost of Goods Sold	6,250	7,500	8,750	7,500
IP Royalty to DevCo (5%)	1,250	1,500	1,750	1,500
Other	5,000	6,000	7,000	6,000
Operating Expenses	1,000	1,000	1,000	1,000
Operating Profit	17,750	21,500	25,250	21,500

The Service applied the ratios of average operating profit to operating assets for the 2004 through 2006 taxable years derived from a group of similar comparable uncontrolled companies located in country M and N to the ManuCo average operating assets for the same period.

This operating profits to operating assets analysis provides a set of comparable company operating profits. The interquartile range for these average comparable company operating profits is \$3,000 to \$4,500.

The ManuCo average reported operating profit for the years 2004 through 2006 (of \$21,500) falls outside this interquartile range. Therefore, the Service determines that an allocation may be appropriate for the 2006 taxable year.

To determine the amount, if any, of the allocation for the 2006 taxable year, the Service compares the ManuCo reported operating profit for 2006 to the median of the comparable company operating profits derived from the uncontrolled distributors' results for 2006.

The median operating profit result for the comparable uncontrolled companies for 2006 is \$3,750.

Based on this comparison, the Service increases the IP royalty that ManuCo paid by \$21,500. This \$21,500 adjustment is the difference between (1) \$25,250 and (2) the median of the comparable company operating profits of \$3,750.

Section 482 Regulations Illustrative Example No. 5

Regulations illustrative example no. 5 describes the adjustment procedure for operating assets and operating profit related to differences in accounts receivable. USM is a U.S. company that manufactures parts for industrial equipment. USM sells these parts to its foreign parent corporation.

For purposes of applying the comparable profits method, 15 comparable uncontrolled manufacturers were identified that are sufficiently similar to USM.

USM has a significantly lower level of accounts receivable than the comparable uncontrolled manufacturers. Since the rate of return on capital employed is to be used as the PLI, both operating assets and operating profits should be adjusted to account for this difference.

The level of operating assets for each comparable uncontrolled company is reduced by the amount (relative to sales) by which they exceed the USM level of accounts receivable. Each comparable uncontrolled company's operating profit is adjusted by deducting an imputed interest income on the excess level of accounts receivable.

This imputed interest income is calculated by multiplying (1) the comparable uncontrolled company's excess accounts receivable amount by (2) an interest rate appropriate for short-term debt.

Section 482 Regulations Illustrative Example No. 6

Regulations illustrative example no. 6 illustrates the adjusting of operating profit for differences in accounts payable. USD is the U.S. subsidiary of a foreign corporation. USD purchases goods from its foreign parent and sells them in the U.S. market.

For purposes of applying the comparable profits method, 10 comparable uncontrolled distributors were identified that are sufficiently similar to USD.

There are significant differences in the level of accounts payable among the comparable uncontrolled distributors and USD. To adjust for these differences, the Service increases the operating profit of the comparable uncontrolled distributors and of USD in order to reflect interest expense imputed to the accounts payable.

The imputed interest expense for each company is calculated by multiplying (1) the company's accounts payable by (2) an interest rate appropriate for its short-term debt.

The Profit Split Method

According to Regulation 1.482-6(a), the profit split method evaluates whether the allocation of the combined operating profit attributable to one or more controlled transactions is at arm's length by reference to the relative value of each controlled party's contribution to that combined operating profit.

The combined operating profit should be derived from the most narrowly identifiable business activity of the controlled entities for which data are available that includes the controlled transactions.

According to Regulation 1.482-6(b), the relative value of each controlled taxpayer's contribution to the success of the relevant business activity should be determined in a manner that "reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity."

Such an allocation is "intended to 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."

The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one member of the controlled group may earn a profit while another member of the group incurs a loss.

In addition, the analyst should not assume that the combined operating profit from the relevant business activity should be shared equally—or (for that matter) in any other arbitrary proportion.

Other Unspecified Methods

Regulation 1.482-4(d)(1) provides that an unspecified method may also be used "to evaluate whether the amount charged in a controlled transaction is arm's-length."

Consistent with the specified transfer pricing methods, 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.

Therefore, an uncontrolled taxpayer will only enter into a particular transaction if none of the alternatives is preferable to that transaction.

For example, the CUT method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price the parties would have agreed to had they resorted directly to a market alternative to the controlled transaction.

Therefore, in establishing whether a controlled transaction achieved an arm's-length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by selecting a realistic alternative to the controlled transaction.

As with any IP transfer pricing method, an unspecified method should not be applied unless it provides the most reliable measure of an arm's-length IP transfer price result under the principles of the best method rule.

SUMMARY AND CONCLUSION

The Regulations related to Section 482 provide guidance with regard to the application of pricing methods for the intercompany transfer of intangible property (including IP) between controlled entities in different national taxing jurisdictions.

All of the Section 482 IP intercompany transfer pricing methods are intended to conclude a fair, arm's-length transfer price, that is, a price that unrelated parties would reach in an arm's-length IP license negotiation.

Of course, the above-described transfer pricing methods are appropriate to a multinational taxpayer involved with the international (but intercompany) transfer of IP for federal income tax compliance purposes. For that purpose, the Section 482 Regulations cautions the taxpayer (and/or the

analyst) to only use the best method for determining the appropriate IP intercompany transfer price.

The Section 482 transfer price methods are also generally applicable for determining an intercompany transfer price related to interstate (versus international) IP transfers. And, the Section 482 transfer price methods are generally applicable for estimating an IP license royalty rate for third-party license fairness opinions, infringement and other litigation economic damages analysis, and other IP-related purposes.

However, in these non-Section 482 IP economic analyses, the analyst is not restricted to using the best method only. Rather, analysts typically reconcile the results of two or more transfer pricing methods in order to synthesize the IP royalty rate conclusion.

In any event, the Section 482 intercompany transfer pricing methods allow IP owner/operators to plan for IP transfers by providing a systematic framework for estimating fair, arm's-length IP license royalty rates.

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Exhibit 1 Regulation Section 1.482-1(d)(1) Five Comparability Criteria

(d) *Comparability*—(1) *In general*. Whether a controlled transaction produces an arm's-length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's-length dealings (comparability factors). While a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Such factors include the following—

- (i) Functions;
- (ii) Contractual terms;
- (iii) Risks;
- (iv) Economic conditions; and
- (v) Property or services.

Exhibit 2
Regulation Section 1.482-1(d)(3)(i) and (ii)(A)
Functional Analysis and Contractual Term Comparability Factors

(3) *Factors for determining comparability.* The comparability factors listed in Section 1.482-1(d)(1) are discussed in this section. Each of these factors must be considered in determining the degree of comparability between transactions or taxpayers and the extent to which comparability adjustments may be necessary. In addition, in certain cases involving special circumstances, the rules under paragraph (d)(4) of this section must be considered.

(i) *Functional analysis.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include—

- (A) Research and development;
- (B) Product design and engineering;
- (C) Manufacturing, production and process engineering;
- (D) Product fabrication, extraction, and assembly;
- (E) Purchasing and materials management;
- (F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;
- (G) Transportation and warehousing; and
- (H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

(ii) *Contractual terms—(A) In general.* Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include—

- (1) The form of consideration charged or paid;
- (2) Sales or purchase volume;
- (3) The scope and terms of warranties provided;
- (4) Rights to updates, revisions or modifications;
- (5) The duration of relevant license, contract or other agreements, and termination or renegotiation rights;
- (6) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and
- (7) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charge in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required even if no interest would be allocated or imputed under Section 1.482-2(a) or other applicable provisions of the Internal Revenue Code or regulations.