

The Comparable Profits Method Under the Temporary Section 482 Regulations: A Radical Attempt to Introduce an Objective Standard for International Transfer-Pricing Activities

Raymond Wacker†
Allan Karnes*
Randall Hahn**

Internal Revenue Code (I.R.C.) section 482 is designed to prevent taxpayers from artificially reducing U.S. source income by manipulating prices of goods bought to or sold from related foreign taxpayers. The specific methods by which the taxpayer should calculate the income from such transactions are described in the Regulations.

This article analyzes the comparable profits method as an attempt to introduce a more objective pricing standard for international transactions between

† Ph.D. University of Houston, 1989; M.S. University of Houston, 1976; M.A. University of Toronto, 1974. Professor Wacker was in public accounting and industry for eight years before entering academia. His research has been published in such journals as *Journal of Corporate Taxation*, *The Southern Illinois University Law Journal*, *Tax Adviser*, *Oil and Gas Tax Quarterly*, and *Weltwirtschaftliches Archiv*. Professor Wacker is a member of the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), and the American Taxation Association (ATA). He holds CPA certification in Illinois.

* J.D. Southern Illinois University, 1986; M.A. Ball State University, 1977. Professor Karnes was in public accounting for five years before entering academia. He is the author of several tax and accounting articles. His articles have appeared in journals such as *North Dakota Law Review*, *The Southern Illinois University Law Journal*, *The International Journal of Accounting*, *The Accounting Educators' Journal*, *The Journal of Taxation*, *The Review of Taxation for Individuals*, *TAXES-The Tax Magazine*, *The Practical Accountant*, and *The CPA Journal*. Professor Karnes is a member of the AAA, the AICPA, the ABA, and the Illinois Bar Association. He is licensed to practice accounting and law in Illinois.

** D.B.A. University of Kentucky, 1984; M.B.A. Murray State University, 1976. Professor Hahn practiced public accounting for five years before entering academia. He recently returned from a six month tour of duty with the tax department of KPMG Peat Marwick in St. Louis. His research has been published in journals such as *Taxation for Lawyers*, *The Southern Illinois University Law Journal*, *North Dakota Law Review*, *Journal of Information Systems*, *The Journal of Taxation*, *TAXES-The Tax Magazine*, *Oil and Gas Tax Quarterly*, *Small Business Taxation*, and *The Ohio CPA Journal*. Professor Hahn is a member of the AAA and the AICPA. He is a licensed CPA in Kentucky.

related parties. The author discusses the benefits to taxpayers of this new method, as well as its shortcomings, and suggests modifications of the Regulations in order to provide more certainty for taxpayers entering into such transactions.

I.

INTRODUCTION

The recent publication of Temporary Treasury Regulations sections 1.482-1 and 1.482-2¹ represents an effort to inject objectivity into the chaotic world of U.S. tax rules governing international transfer-pricing activities. Ostensibly an effort to implement the provisions of the U.S. Department of the Treasury's 1988 White Paper² regarding the "commensurate with income" standard of Internal Revenue Code (I.R.C.) section 482,³ the Temporary

1. Intercompany Transfer Pricing Regulations Under Section 482, Temp. Treas. Reg. §§ 1.482-0T to -7T (1993). The Temporary Regulations replace the amendments to Treas. Regs. §§ 1.482-1, -2 proposed in 1992. Intercompany Transfer Pricing and Cost Sharing Regulations Under Section 482, Prop. Treas. Reg. §§ 1.482-1 to -2, 57 Fed. Reg. 3571 (1992). For a discussion of the 1992 proposed regulations see generally Alan W. Granwell & Kenneth Klein, "Objective" Tests of Transfer Pricing Prop. Regs. Require Subjective Determinations, 76 J. TAX'N 308 (1992).

2. A Study of Intercompany Pricing Under Section 482 of the Code, I.R.S. Notice 88-123, 1988-2 C.B. 458 [hereinafter White Paper]. See generally George P. Carlson et al., *The Section 482 White Paper: Highlights and Implications*, 41 TAX NOTES 547 (1988); James P. Fuller, *The IRS Section 482 White Paper*, 41 TAX NOTES 655 (1988).

3. The following sentence was added to I.R.C. § 482 (1988) by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986): "In the case of a transfer (or license) of an intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." I.R.C. § 482 (1988). This sentence, together with companion provisions of I.R.C. §§ 367(d)(2)(A), 936(h)(5)(C)(i)(1) (1988), are referred to as the "super-royalty provisions."

The intention of this sentence is to force the income derived from the intangible to be recognized by the developer of the intangible. The legislative history of the "commensurate with income provisions" is a clear reflection of Congressional concern over the Service's inability to allocate income of high-profit potential intangibles to U.S. corporations. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-637 to -638 (1986); H.R. REP. NO. 426, 99th Cong., 1st Sess. 420-27 (1985). This legislation would nullify certain adverse results in the landmark cases of *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), *rev'd in part, aff'd in part*, 856 F.2d 855 (7th Cir. 1988), and *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172 (1985). In *Eli Lilly*, the IRS was unable to allocate all income associated with high profit potential manufacturing intangibles transferred to a Puerto Rican subsidiary by the U.S. parent corporation. 84 T.C. at 1133, 1153. The Seventh Circuit did, however, impose a profit split. *Eli Lilly*, 856 F.2d at 872. In *Ciba-Geigy*, the Tax Court prohibited the Service from disallowing deductions related to fixed long term licensing agreements with a stated royalty rate. 85 T.C. at 236.

The super-royalty language will also allow the IRS to adjust long-term royalty contracts so that each year can be treated independently. This action is in part a legislative rejection of *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973) (discussed in White Paper, *supra* note 2, at 477). In *R.T. French*, the Service was unable to adjust a fixed long term controlled royalty agreement covering food processing patents which met arm's-length standards at the time of inception but not during the year under audit due to subsequent events that were not known to the parties at the time of the contract. 60 T.C. at 848. See generally Friedhelm Jacob, *The New "Super-Royalty" Provisions of Internal Revenue Code 1986: A German Perspective*, 27 EUR. TAX'N 320 (1987); Marc M. Levey & Stanley C. Ruchelman, *Section 482 - The Super Royalty Provisions Adopt the Commensurate Standard*, 41 TAX LAW. 611 (1988).

Regulations attempt to define the terms under which cross-border pricing schemes meet the arm's-length standard of I.R.C. section 482. By imposing a myriad of detailed new procedures covering transfer-pricing methodologies,⁴ cost-sharing arrangements,⁵ buy-in and buy-out rules,⁶ and documentation requirements,⁷ the new rules are certain to significantly affect the manner in which multinational firms structure their cross-border transactions.

The White Paper was mandated by Congress to serve as a study of the regulatory implications of the "commensurate with income" standard and to update transfer-pricing regulations that many regarded as antiquated.⁸ The Temporary Regulations represent the Treasury's latest thinking on how to regulate the division of profits earned by multinational firms that operate in increasingly complex world markets and enjoy growing opportunities to engage in transfer-pricing.

This article will discuss the implications of a critical aspect of the Temporary Regulations, namely the comparable profit method. First, the article examines the operational definition of I.R.C. section 482 and the position of the comparable profit method among transfer-pricing methods. Next, the actual operation of the comparable profit method is analyzed and illustrated for international firms that employ this transfer-pricing method. Finally, the ar-

4. Temp. Treas. Reg. § 1.482-4T (1993) substantially revises U.S. tax rules governing the international sale or transfer of intangible property. Section 1.482-4T(a) establishes three methods, which, unlike in the 1992 proposed regulations are no longer listed in hierarchical order: the comparable uncontrolled transaction method, the comparable profits method, and other non-prescribed methods. See *id.* With regard to intangible property, the Temporary Regulations are an outgrowth of Prop. Treas. Reg. § 1.482-2(d), 57 Fed. Reg. 3579 (1992), which had already abandoned current transfer-pricing methods. Prop. Treas. Reg. § 1.482-2(d)(2)(iii), 57 Fed. Reg. 3580 (1992), established the three following methods of pricing intangibles in the following order of preference: (1) the matching transaction method, *id.* § 1.482-2(d)(3), 57 Fed. Reg. 3580 (based with minor amendment on the White Paper's exact comparable method, see White Paper, *supra* note 2, at 485-87); (2) the comparable adjustable transaction method, *id.* § 1.482-2(d)(4), 57 Fed. Reg. 3583 (similar to the White Paper's inexact comparable method, see White Paper, *supra* note 2, at 90-94); and (3) the new comparable profits method, *id.* § 1.482-2(d)(5), 57 Fed. Reg. 3583.

Apart from the rules governing the comparable profits method, the Temporary Regulations do not substantially alter the rules governing the sale of tangible property. Temp. Treas. Reg. § 1.482-3T(a) (1993) retains the comparable profits method but modifies the other methods. The comparable uncontrolled price method, *id.* § 1.482-3T(b), the cost-plus method, *id.* § 1.482-3T(c), and the resale price method, *id.* § 1.482-3T(d), reflect the modifications made to the methods set out in the proposed regulations, although as mentioned above, there is no longer any preferential ranking of methods. Nonprescribed methods, commonly referred to as the fifth method, may be used as a last resort if the taxpayer can demonstrate the inapplicability of the other methods. See *id.* § 1.482-3T(e)(2).

5. Prop. Treas. Reg. § 1.482-2(g), 57 Fed. Reg. 3595 (1992). The cost-sharing rules, I.R.C. § 1.482-2(g) (1988), are the only part of the Proposed Regulations that were not withdrawn when the Temporary Regulations were published. The Temporary Regulations have not dealt with cost-sharing rules.

6. Prop. Treas. Reg. § 1.482-2(g)(4)(iv), 57 Fed. Reg. 3599 (1992). The buy-in and buy-out rules belong to the cost-sharing provisions of the Proposed Regulations that were retained when the Temporary Regulations were issued.

7. Temp. Treas. Reg. § 1.482-3T(e)(2) (1993).

8. See generally H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-637 to -638 (1986).

article considers the policy issues that should be discussed before final regulations are promulgated.

A. *The Role of I.R.C. Section 482 in Transfer-Pricing Regulation*

Internal Revenue Code section 482 governs international transfer-pricing activities. This section of the Code authorizes the Internal Revenue Service (IRS) to allocate gross income, deductions, credits, and other allowances among two or more organizations, trades, or businesses⁹ under common ownership or control¹⁰ whenever the allocation is needed "in order to prevent evasion of taxes¹¹ or clearly to reflect the income."¹² In short, section 482 grants the IRS broad authority to recompute taxable income resulting from controlled international transactions¹³ to reflect the tax liabilities that would have resulted from arm's-length dealings between independent parties.¹⁴ The

9. I.R.C. § 482 (1988) applies to any form or combination of entities provided that the required element of control is present. See Treas. Reg. § 1.482-1(a)(1980).

10. Indicative of the broad discretion granted to the IRS, Congress has never legislated any quantifiable definition of ownership or control under I.R.C. § 482. Nor have the courts imposed any such test. Treas. Reg. § 1.482-1(a)(3) (1980) provides that control can signify any form of direct or indirect control, whether or not legally enforceable, and however exercisable. See *id.* Control is defined exclusively as to the exercise of practical or economic control over the entities. See *Hall v. Commissioner*, 32 T.C. 390, 409-10 (1959), *aff'd*, 294 F.2d 82, 85 (5th Cir. 1961). The legal right of control is considered irrelevant. See *id.*

11. For purposes of I.R.C. § 482 (1988), the term "tax evasion" would include any transfer-pricing scheme which effectively minimizes U.S. tax liability. The term is synonymous with "tax avoidance." *Asiatic Petroleum Co. v. Commissioner*, 31 B.T.A. 1152, 1158, *aff'd*, 79 F.2d 234 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935).

12. I.R.C. § 482 (1988). Prior to its amendment by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 2562-63, 100 Stat. 2085 (1986), I.R.C. § 482 was limited to the following sentence:

In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

I.R.C. § 482 (1982).

Since the codification of the Internal Revenue Code of 1954, the only change to this section has been the addition of the commensurate with income sentence quoted *supra* note 3. See generally James P. Fuller, *Section 482 Revisited*, 31 TAX L. REV. 475, 476-78 (1976); Harlow N. Higinbotham et al., *Effective Application of the Section 482 Transfer Pricing Regulations*, 42 TAX L. REV. 293 (1987).

13. The term "controlled transaction" is used to denote any form of transaction between two or more controlled taxpayers. Treas. Reg. § 1.482-1(a)(4) (1980) defines a controlled taxpayer as any one of two or more organizations, trades, or businesses owned or controlled by identical interests. *Id.* For the definition of control, see *supra* note 10.

14. Treas. Reg. § 1.482-1(b)(1) (1968) attempts to place unrelated taxpayers on a tax parity with related taxpayers. Prop. Treas. Reg. § 1.482-1(b)(1), 57 Fed. Reg. 3578 (1992) liberalized the arm's-length standard. A transaction meets the arm's-length standard if uncontrolled taxpayers, each exercising sound business judgment within the relevant industry and with full knowledge of the facts, would have agreed to similar contractual terms. The IRS may treat each of the individual members of a commonly controlled group as a separate entity, transactions

purpose of section 482 is to prevent the tax-motivated shifting of income to overseas affiliates subject to lower tax rates and to prevent similar manipulations of offsetting losses.

The judicial history of section 482 implies that IRS allocations need only reflect the economic reality of the questioned transactions.¹⁵ A controlled taxpayer challenging a section 482 reallocation has the burden of overcoming a presumption of correctness and establishing that the Service acted arbitrarily, capriciously, or unreasonably.¹⁶ The IRS need not demonstrate a motive of tax avoidance or a lack of sound business purpose.¹⁷

*B. The Position of the Comparable Profits Method in I.R.C.
Section 482 Regulations*

The most radical feature of the Temporary Regulations is the introduction of the comparable profits method (CPM). The CPM is a new transfer-pricing method applicable to controlled transfers of both tangible and intangible property.¹⁸ The CPM is a liberalization of the comparable profit interval (CPI), first elaborated in the 1992 Proposed Regulations.¹⁹ The CPM is based on a series of detailed rules intended to determine an acceptable range of profit levels that would satisfy the arm's-length requirement of section 482 pricing methods. The CPM represents a significant departure from prior section 482 rules in three ways: (1) it substitutes a profits-based approach for the comparable transaction approach that has long dominated section 482 regulations and related litigation; (2) it subjects affected controlled sales of tangible property to the commensurate with income standard;²⁰ and (3) it

between which are taxable events to be conformed to the economic realities that would have obtained between independent parties conducting identical transactions. The Service may also consider all commonly controlled entities as parts of the same unitary business. The issue of the arm's-length standard is discussed further in *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233, 1234 (Ct. Cl. 1969); see also *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 584 (1989), *aff'd*, 933 F.2d 1084, 1089 (2d Cir. 1991).

15. *United States v. Rexach*, 331 F. Supp. 524 (D.P.R. 1971).

16. *Your Host, Inc. v. Commissioner*, 58 T.C. 10, 23-24 (1972), *aff'd*, 489 F.2d 957 (2d Cir. 1973).

17. *Id.*

18. Temp. Treas. Reg. § 1.482-5T (1993). Section 1.482-4T(b) has also expanded the definition of intangible property to include any of the following items that have "substantial value independent of the services of any individual: (1) Patents, inventions, formulae, 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, studies, forecasts, estimates, customer lists, or technical data; and (6) other similar items." Temp. Treas. Reg. § 1.482-4T(b) (1993). The cross-reference is to I.R.C. § 936(h)(3)(B) (1988) which contains a similar listing of intangibles and represents the specific Code reference in the commensurate with income provision in I.R.C. § 482 quoted *supra* note 3.

19. Prop. Treas. Reg. § 1.482-2(f), 57 Fed. Reg. 3586 (1992).

20. Temp. Treas. Reg. § 1.482-3T(a) (1993). The significance of subjecting controlled transfers of tangible property to the commensurate with income standard was discussed at some length in the explanation to the Proposed Regulations. 57 Fed. Reg. 3574 (1992). While the notes accompanying the Temporary Regulations make no similar comments, the causes and the

subjects controlled transfers of both tangible and intangible property to an identical transfer-pricing methodology.

Transfer-pricing under the comparable transaction approach is determined by comparing intrafirm prices with those in arm's-length transactions occurring in the free market. Difficulties in applying the comparable transaction approach arise when no comparable sales can be found, as commonly occurs in the case of unique products that are typically transferred solely in controlled transactions.

The Service's de-emphasis of the comparable transaction approach in the Temporary Regulations is in keeping with the history of the commensurate with income legislation. Congress had become concerned with the practical difficulties in applying the comparable approach.²¹ The IRS has also conceded that current section 482 regulations rely too heavily on finding comparable transfer prices or comparable transactions. The current regulations provide little guidance for determining transfer prices in the absence of comparables.²²

Under pre-1993 transfer-pricing regulations, both the IRS and the taxpayer are subject to the tedious process of determining the appropriate transfer price on each controlled transaction. Under the CPM scheme, rather than inquiring into individual profit components, the IRS need only determine that overall net profits lie outside the permitted parameters.²³

The new rules also enable the same transfer-pricing methodology to be used in cases of controlled transactions of tangible and intangible property. The IRS had hitherto mandated different transfer-pricing methodologies due to inherent divergences in the two classes of property.

Subjecting tangible property transfers to the commensurate with income standard allows the Service to treat as interdependent the profits on interrelated sales and licensing agreements of tangible and intangible property.

consequences mentioned in the explanation to the Proposed Regulations of subjecting controlled transactions of tangibles to the commensurate with income standard will be the same under the Temporary Regulations.

21. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-637 to -638 (1986). The courts have experienced difficulty in applying the comparable approach. See, e.g., *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084, 1089 (2d Cir. 1991); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 375-76 (1987); *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172 (1985); *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985); *Hospital Corp. v. Commissioner*, 81 T.C. 520, 554 (1983); *United States Steel Corp. v. Commissioner*, 36 T.C.M. (CCH) 586 (1977), *rev'd*, 617 F.2d 942, (2d Cir. 1980).

22. White Paper, *supra* note 2, at 459-61.

23. The CPM rules would also have the effect of obviating the result of *Bausch & Lomb*, 92 T.C. 525. In *Bausch & Lomb*, a U.S. manufacturer entered into a nonexclusive licensing agreement with its wholly owned Irish subsidiary. *Id.* at 541. The subsidiary used Bausch & Lomb's patents to manufacture contact lenses that were sold to the parent corporation and its foreign affiliates for worldwide distribution. *Id.* at 557. The IRS tried to treat the Irish firm as a contract manufacturer so that the price of the lenses and the royalties paid to the U.S. parent were interdependent. *Id.* at 583. The court ruled that each source of income had independent significance. *Id.* at 584. Similar results were reached in *Sundstrand Corp. v. Commissioner*, 96 T.C. 226, 226 (1991).

While this saves the Service from having to determine which intercompany transactions have failed the arm's-length standard,²⁴ the new CPM rules place severe definitional and statistical burdens on multinational taxpayers. The new rules also require the use of advanced statistical techniques absent in prior section 482 regulations. Although the problems associated with calculating the CPM may be insurmountable, multinational interests must attempt to comply with the new rules or be subject to an accuracy-related penalty of twenty percent under I.R.C. section 6662(a).²⁵ In cases of "gross valuation misstatements," the penalty can be assessed at forty percent.²⁶ If a substantial, as opposed to a gross, understatement of income tax were to occur, the penalty could be assessed whenever the reported understatement of tax exceeded the greater of ten percent of the correct tax liability or \$10,000.²⁷

C. Theoretical Basis of the CPM

The CPM is meant to define a range of profits that would have been earned by a controlled taxpayer on cross-border transfers²⁸ involving tangible and intangible property had its transfer-price been stated in terms of prevailing market rates. The Service constructs a CPM by applying prescribed financial ratios—derived from like transactions of uncontrolled taxpayers

24. The Service's authority for applying the commensurate with income standard to controlled transfers of tangible property is uncertain. The specific language of I.R.C. § 482 (1988) subjects only income from intangibles to commensurate with income rules. See *supra* note 3. The White Paper, *supra* note 2, gives limited coverage to the question of tangible sales. In the explanation accompanying the Proposed Regulations, the IRS attempts to justify this action as being necessary in cases involving tangible property incorporating an intangible asset and where the transfer of services is indistinguishable from the transfer of intangible property. See 57 Fed. Reg. 3574 (1992).

25. Under this provision, a penalty can be assessed whenever the taxpayer cannot demonstrate reasonable cause to support its transfer-pricing scheme and a good faith effort to comply with I.R.C. § 482 Regulations. I.R.C. § 6662(a) (1992). Exceptions relating to good faith and reasonable cause appear in I.R.C. § 6664(c)(1) (1992).

26. I.R.C. § 6662(h)(1) (1992). This penalty can apply in any instance where the taxpayer is determined to have been negligent or to have disregarded I.R.C. § 482 regulations. See I.R.C. § 6662(b)(1)(1992).

27. I.R.C. § 6662(d) (1992). Section 6662(d)(1)(B) applies the \$10,000 threshold in the case of corporations other than S corporations or personal holding companies. Foreign personal holding companies as defined in I.R.C. § 552 follow a \$5,000 threshold.

To further complicate taxpayer compliance, existing § 6662 Regulations seem ill-suited to deal with the complexities of the CPM and no legal cases regarding these penalties yet exist. IRS Deputy Associate Chief Counsel (International) Charles Tipllett has announced that the Service will not issue any § 6662 Regulations prior to the publication of the final I.R.C. § 482 Regulations. See statement of Charles Tipllett, noted in Kathleen Matthews, *IRS To Delay Issuing Section 482 Penalty Regulations*, 4 TAX NOTES INT'L 577 (1992).

28. Prop. Treas. Reg. § 1.482-2(d)(1)(ii)(C), 57 Fed. Reg. 3579 (1992) defined a controlled transfer as any transfer between members of a group of controlled taxpayers. Proposed § 1.482-2(d)(1)(ii)(B), 57 Fed. Reg. 3579, expanded the definition of the transfer of intangibles to cases where the property is licensed, sold, assigned, loaned, contributed, or otherwise made available in any manner. While neither term is defined in the Temporary Regulations, both definitions provided in the Proposed Regulations are consistent with usage implied in the new rules.

whose operations are similar in product type or function to those of the controlled taxpayer—to the financial data of the controlled party.²⁹

The new rules have abandoned the strict hierarchical approach to transfer-pricing methodologies. The new “best method rule” provides that the taxpayer need only select the optimal transfer-pricing method regardless of its position in the Service’s ranking of competing methods. The taxpayer need only demonstrate that the method selected provides the most accurate determination of arm’s-length results given the facts and circumstances of the transaction under review.³⁰ The taxpayer is not required to show that the other methods are inapplicable. In considering which method provides the best measure of an arm’s-length result, facts to be considered include the reliability of the data, the degree of comparability between controlled and uncontrolled transactions, and the extent of the adjustments required to apply the method.³¹ Whether or not the CPM constitutes the appropriate transfer-pricing method depends on the Service’s ability to demonstrate, under the given facts and circumstances, that either another method is preferable,³² or two competing methods would produce inconsistent results.³³

For purposes of applying the “best method rule,” the CPM can normally be used in any controlled transaction except where the controlled party uses valuable, non-routine intangible assets that it (1) acquired in a noncontrolled transaction and with which it continues to assume significant risks and possesses the right to significant economic benefits or (2) developed internally.³⁴ The CPM then serves two interrelated functions: (1) to provide a voluntary means of validating the application of other transfer-pricing methods enumerated in the Temporary Regulations,³⁵ and (2) to calculate the appropriate transfer-price in those situations where the IRS has determined that the CPM is the appropriate method of accounting for cross-border controlled transactions. Therefore, the CPM not only can override competing transfer-pricing tax calculation schemes, but can exert a critical influence in determining the correct transfer-price in international transactions involving tangible and intangible property.

29. Temp. Treas. Reg. § 1.482-5T(a) (1993).

30. Temp. Treas. Reg. § 1.482-1T(b)(2)(iii)(A) (1993).

31. *Id.*

32. *Id.*

33. Temp. Treas. Reg. § 1.482-1T(b)(2)(iii)(B) (1993).

34. Temp. Treas. Reg. § 1.482-5T(a) (1993).

35. Temp. Treas. Reg. § 1.482-1T(d)(2)(i)(B) (1993). The CPM’s predecessor, the CPI, was not only a critical component of prior CPM rules but was actually required to confirm the validity of all transfer-pricing allocation methods applicable to tangible and intangible property except for the matching transaction method and the comparable uncontrolled price method. *See* Prop. Treas. Reg. § 1.482-2(e)(1), 57 Fed. Reg. 3574 (1992).

II. MECHANICS OF DETERMINING THE APPROPRIATE TRANSFER- PRICE UNDER THE CPM

The Temporary Regulations provide five sequential steps that must be followed in order to construct the acceptable profit range under the CPM.³⁶ The steps are interdependent, and certain steps may have to be recalculated to take into account results derived in succeeding steps. The procedure is:

- 1) Select the tested party;³⁷
- 2) Determine the appropriate comparable parties;³⁸
- 3) When applicable, adjust the data set of the tested party and appropriate comparable parties;³⁹
- 4) Determine the appropriate profit level indicator; and⁴⁰
- 5) Construct the arm's-length range.⁴¹

A. Step 1: Selecting the Tested Party

Section 482 defines the tested party as that party to the controlled cross-border transactions that normally performs the simplest and therefore most easily compared operations.⁴² The tested party need not be the audited taxpayer, provided that it is still a party to the controlled transactions under examination.⁴³ For example, if the IRS were to audit the sale of tangible property by a U.S. parent corporation to a foreign subsidiary, either corporation could qualify as the tested party.

In the case of a license of intangible property, the tested party will ordinarily be the licensee. The tested party will also be the party in the controlled transaction that does not use valuable, non-routine intangible assets that it (1) acquired in a noncontrolled transaction and with which it continues to assume significant risks and possesses the right to significant economic benefits or (2) developed internally.⁴⁴ Since use of the CPM is clearly inappropriate where either of these conditions obtain, such restrictions are meaningless. The Temporary Regulations also require that the CPM be constructed separately for each industry segment as defined in Treasury Regulation section 1.6038A-3(c)(7).⁴⁵ In each case, the selection of the tested party is also governed by the availability of reliable data.

36. Temp. Treas. Reg. § 1.482-5T(a)-(d) (1993).

37. Temp. Treas. Reg. § 1.482-5T(b) (1993).

38. Temp. Treas. Reg. § 1.482-5T(c)(1) (1993).

39. Temp. Treas. Reg. § 1.482-5T(c)(2) (1993).

40. Temp. Treas. Reg. § 1.482-5T(e) (1993).

41. Temp. Treas. Reg. § 1.482-5T(d) (1993).

42. Temp. Treas. Reg. § 1.482-5T(b)(1) (1993).

43. *Id.*

44. *Id.* See *supra* text accompanying note 34.

45. Temp. Treas. Reg. § 1.482-5T(b)(2) (1993).

B. Step 2: Determining the Appropriate Comparable Parties

In order to compute the arm's-length range under the CPM, the financial results of the tested party must be compared with financial results obtained by similarly situated uncontrolled multinational taxpayers. The CPM, which is more flexible than the previously proposed CPI, requires only that the tested party and similarly situated uncontrolled taxpayers be broadly similar. Indeed, section 482 permits significant product diversity and limited functional diversity.⁴⁶ However, similarity of product and function are still desirable, and section 482 requires the use of available reliable data pertaining to uncontrolled taxpayers with the same industry classification as the tested party.⁴⁷ Data relating to dissimilar groups of taxpayers would require greater adjustments and would result in narrower CPM ranges.⁴⁸ Other basic factors to be considered in determining comparability between the tested party and similarly situated taxpayers include functions performed by both groups of taxpayers, relative risks, contractual terms, economic conditions and property or services.⁴⁹

C. Step 3: Adjusting the Data Set Relating to the Tested Party and Comparable Parties

The financial data reported by both parties must be adjusted in order to guarantee the reliability and consistency of the profit level indicators (PLIs) used in the successive steps and to achieve a degree of similarity between the tested party and the comparable parties. In the case of comparable parties, the data must be adjusted to resemble a company operating within the financial environment of the tested party. Such adjustments are, however, limited to the extent that they have a definite and reasonably ascertainable effect on the operating profits and asset values of the comparable parties.⁵⁰

The data must represent actual financial results, rather than projections. The data must also represent a sufficient number of years to measure reasonably returns that accrue to comparable parties with risk characteristics similar to those facing the tested party.⁵¹ Normally, the data will be averaged over a three-year period treating the audited year as the last year.⁵²

Section 482 also requires consideration of qualitative similarities between the tested party and uncontrolled parties stated in terms of operational size, relevant markets, and other unspecified factors.⁵³ In each instance, the finan-

46. Temp. Treas. Reg. § 1.482-5T(c)(1) (1993).

47. *Id.*

48. *Id.*

49. Temp. Treas. Reg. § 1.482-1T(c)(1)(i) (1993).

50. Temp. Treas. Reg. § 1.482-5T(c)(1) (1993).

51. Temp. Treas. Reg. § 1.482-5T(d)(1) (1993).

52. *Id.*

53. *Id.*

cial data of the tested party must be adjusted to reflect any section 482 adjustments not within the scope of the CPM regulations.⁵⁴

Example 1:

Assume the following data (reflected in \$ thousands) relating to controlled taxpayer X, treated as the tested party, and uncontrolled taxpayer Y, as an average for the years 1993-1995.

	X	Y
Assets	\$1,000	\$ 175
Sales	1,500	200
Cost of Goods Sold	<u>(1,000)</u>	<u>(164)</u>
Gross Income	500	36
Operating Expenses	<u>(320)</u>	<u>(26)</u>
Operating Income	180	10

Prior to the application of any profit level indicator, the District Director determines under Treasury Regulation section 1.482-2(b)(2)(1968) that the operating expenses of X do not properly reflect the cost of management services performed by a foreign subsidiary. Accordingly, an upward adjustment of \$20 is made. Operating expenses are adjusted to \$340, thereby reducing operating income to \$160.

Adjustments that account for the material differences between the asset and income statement figures of the tested and uncontrolled parties also precede the calculation of the profit level indicators.⁵⁵

Example 2:

Assume the same facts present in Example 1. Upon further examination, the district director determines that Y's balance sheet contains an unusually high ratio of long-term investments to total assets when compared to X. It is subsequently determined that \$50 of Y's long term assets represents land holdings which produce no current revenues and are invested in a manner irrelevant to the controlled transactions under audit. To safeguard the requirement of comparability, the excess long-term assets are segregated and ignored when calculating the constructive operating profits of Y. Therefore, Y's total assets for the CPM analysis are restated as \$125. Had the segregated assets produced any operating income, this figure too would have been omitted from Y's reported operating income within the applicable industry segment.

D. Step 4: Determining the Appropriate Profit Level Indicator

The Temporary Regulations prescribe only three specific profit-level indicators:

1. *Rate of return on capital employed.* This rate of return is defined as the ratio of operating profit⁵⁶ to operating assets.⁵⁷ Ordinarily, this ratio is to

54. Temp. Treas. Reg. § 1.482-5T(b)(3) (1993).

55. Temp. Treas. Reg. § 1.482-5T(c)(2) (1993).

56. Temp. Treas. Reg. § 1.482-5T(f)(4) (1993) defines operating profit as gross profit less operating expenses. Operating profit would then include all income derived from the industry

be employed only if the tested party's ratio of fixed assets to total assets is quite high or if the party employs substantial working capital that plays a significant role in generating operating capital.⁵⁸

2. *Financial ratios.* The relationship between income and costs or sales revenue is used to calculate the appropriate financial ratio. The Temporary Regulations require a higher degree of comparability between tested and comparable parties since financial ratios do not directly relate operating profit to the relevant levels of investment and risk in a trade or business.⁵⁹ Appropriate financial ratios include:

a) Ratio of operating profit to sales.⁶⁰ Unfortunately, the Temporary Regulations offer no additional guidance as to when this ratio may be appropriate.

b) Ratio of gross profit⁶¹ to operating expenses.⁶² This ratio applies only in cases where the composition of operating expenses experienced by the tested party is substantially similar to that noted by the comparable parties.⁶³

3. *Other profit level indicators.* Other PLIs may be used if they provide reasonable assurance that the results approximate income levels that would have occurred at arm's length. Other potential financial ratios will be considered if adequate reliable data is unavailable. If employing other PLIs, it is the duty of the taxpayer to establish the validity of each PLI. It is doubtful, however, that the controlled taxpayer will first be able to demonstrate the inapplicability of the three specified PLIs.⁶⁴

segment being tested by the CPM. Operating profit specifically excludes interest and dividend income earned by the tested and comparable parties, income from sources that are not being tested by the CPM, and extraordinary gains and losses from noncontinuing operations of the tested party. *Id.*

57. Under Temp. Treas. Reg. § 1.482-5T(f)(6) (1993), "operating assets" denotes the value of all assets, both current and fixed, employed in the relevant industry segment. The term specifically excludes investments in subsidiaries, excess cash, and portfolio investments. *Id.*

58. Temp. Treas. Reg. § 1.482-5T(e)(1) (1993).

59. Temp. Treas. Reg. § 1.482-5T(e)(2) (1993). The definitions and use of financial ratios in the Temporary Regulations are virtually identical to those relating to margins in the CPI of the Proposed Regulations. See Prop. Treas. Reg. § 1.482-2(f)(6)(iii)(C)(2), 57 Fed. Reg. 3575 (1992).

60. Temp. Treas. Reg. § 1.482-5T(e)(2)(i) (1993). "Sales revenue" is defined as the aggregate of revenue from the sale of goods and services less discounts and returns. Temp. Treas. Reg. § 1.482-5T(f)(1) (1993). Accounting rules generally practiced within the industry of the controlled party must be used. *Id.*

61. Temp. Treas. Reg. § 1.482-5T(f)(2) (1993) defines gross profit as sales revenue less cost of goods sold.

62. Temp. Treas. Reg. § 1.482-5T(e)(2)(ii) (1993). "Operating expenses" are defined in Temp. Treas. Reg. § 1.482-5T(f)(3) (1993) as all expenses other than cost of goods sold. The term specifically excludes interest expense, U.S. income taxes, and foreign income taxes described in Treas. Reg. § 1.901-2(a) (1983). The term would, however, include expenses associated with advertising, sales, marketing, promotion, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization. See *id.*

63. Temp. Treas. Reg. § 1.482-5T(e)(2)(ii) (1993).

64. Temp. Treas. Reg. § 1.482-5T(e)(3) (1993).

It is clear, moreover, that controlled taxpayers may not use a profit split method in conjunction with the CPM. Despite the predominant role of the comparable profit split method in determining the CPI under the previously proposed regulations,⁶⁵ the new rules permit the use of a profit split technique only in the case of valuable nonroutine intangibles for which the rules specifically bar the use of the CPM.⁶⁶

E. Step 5: Constructing the Arm's-Length Range Under the CPM

The CPM relies upon a range of constructive operating profits derived by applying the PLIs from the data of comparable parties to the tested party.⁶⁷ Unlike the proposed CPI which developed the appropriate profit range at the point where results derived from several PLIs converged around a reasonably narrow range,⁶⁸ the CPM defines each profit range in terms of a single PLI.⁶⁹ Whether a particular constructive operating profit falls within the permitted interval is normally a matter of statistical judgment on the part of the IRS.

The CPM provides that the arm's-length range can be determined in two ways depending upon the degree of comparability between the tested party and the comparable parties and the adjustments that were made to account for the differences. If adjustments described in Step 3 were made to the operating profits and assets of any of the comparable parties, the permitted range will include all the constructive operating profits calculated by applying a single PLI to the data of each comparable party.⁷⁰

*Example 3.*⁷¹

USS is the wholly owned U.S. subsidiary of FP, a foreign corporation. USS is under audit for its 1995 taxable year. The district director determines that USS qualifies as the tested party. FP manufactures a consumer product for worldwide distribution and has developed a trademark that has significant marketing value in the United States. USS imports the finished product and distributes it within the United States under that trademark. USS's income attributable to the trademark is material in relation to the income attributable to its sale of the product.

65. Prop. Treas. Reg. § 1.482-2(f)(6)(iii)(C)(3), 57 Fed. Reg. 3575 (1992).

66. Temp. Treas. Reg. § 1.482-5T(a) (1993). The restricted use of a profit split technique even when constructing the CPM is puzzling. The White Paper made extensive use of profit split methods. See White Paper, *supra* note 2, at 469-71. The Service's litigation position in *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084, 1089 (2d Cir. 1991), was essentially a profit split argument. Since income from both tangible and intangible sources was interchangeable, it was irrelevant as to which source of income served as the basis for reallocation. See 92 T.C. at 604. Allocations based on a profit split assumption was the Service's most successful argument in *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), *rev'd in part, aff'd in part*, 856 F.2d 855 (7th Cir. 1988).

67. Temp. Treas. Reg. § 1.482-5T(d)(1) (1993).

68. Prop. Treas. Reg. § 1.482-2(f)(7), 57 Fed. Reg. 3589 (1992).

69. Temp. Treas. Reg. § 1.482-5T(d)(1) (1993).

70. Temp. Treas. Reg. § 1.482-5T(d)(2)(i) (1993).

71. See also Temp. Treas. Reg. § 1.482-5T(g)(Example No. 1) (1993).

For the taxable years 1993 through 1995, USS shows the following results (in \$ thousands):

	1993	1994	1995	Average
Assets	\$310,000	310,000	310,000	310,000
Sales	500,000	560,000	500,000	520,000
Cost of Goods Sold	393,000	412,400	400,000	401,800
Purchases from				
FP	350,000	365,000	350,000	355,000
Other	43,000	47,400	50,400	46,800
Gross Profit	107,000	147,600	100,000	118,200
Operating Expenses	80,000	110,000	110,000	100,000
Operating Profit	27,000	37,600	(10,000)	18,200

The above data from USS, averaged over three years, results in the following PLI ratios:

Operating Profit/Assets (OP/A)	5.9%
Operating Profit/Sales (OP/S)	3.6%
Gross Profit/Operating Expenses (GP/OE)	118.2%

In order to construct the CPM, the District Director obtains data from ten independent operators of wholesale distribution companies. After examining this data, the District Director selects only the companies in the most similar types of businesses and which perform the most similar functions to USS. He therefore selects only eight of the independent operators to serve as comparable parties. An analysis of the information available on these companies shows that their PLIs do not fluctuate significantly when at least three years are included in the average. The District Director also determines that the ratio of operating profits to sales provides the best measure of comparability. Calculating the average ratio of operating profits to sales for each of the eight uncontrolled distributors and applying each ratio to USS would produce the following constructive operating profits (COP) for USS:

<u>Unrelated Distributor</u>	<u>OP/S</u>	<u>USS COP</u>
A	4.2%	\$21,840
B	9.6%	49,920
C	7.1%	36,920
D	4.2%	21,840
E	7.1%	36,920
F	3.6%	18,720
G	3.1%	16,120
H	1.8%	9,360
I	12.6%	39,060

Since the financial data of the comparable parties did not require adjustment and since the products sold by the independent distributors are sufficiently similar to provide for the construction of the arm's-length range as including all constructive operating profits derived from comparable parties, the acceptable range is stated as any such profit level between \$9,360 and \$49,920. USS's average reported operating profit of \$18,200 is well within this range. Therefore, the District Director determines that no allocation should be made under section 482 even though USS's reported operating profit for 1995, a loss of \$10 million, is clearly outside of the acceptable range.

If no such adjustments were made to the data of any of the comparable parties, then the permitted range would ordinarily consist of the interquartile range from the 25th to the 75th percentile of the constructive operating profits derived from the PLI of the comparable parties utilized.⁷² If the taxpayer can justify the use of other statistical techniques, such as statistical measures of central tendency relating to tests of means and variances, these techniques may be employed instead of the interquartile range to define the arm's-length range.⁷³ However, both the interquartile method and the use of other statistical techniques require a minimum of four comparable parties. None of the four parties require data adjustments.⁷⁴

*Example 4:*⁷⁵

Assume the same facts as in Example 3 except that the District Director is unable to find the requisite four comparable parties whose product type and function are sufficiently similar to avoid adjustments to the data of the comparable parties enumerated in Step 2. Instead, the District Director finds seven other parties and makes the needed adjustments. He also determines that the rate of return on capital, i.e., operating profits/assets, constitutes the appropriate PLI. Applying the ratio achieved by the following unrelated distributors to USS would lead to the following constructive operating profits (COP) of USS:

Unrelated Distributor	USS OP/A	COP
A.....	6.2%	\$19,220
B.....	9.5%	29,450
C.....	18.7%	57,970
D.....	2.8%	8,680
E.....	9.5%	29,450
F.....	7.1%	22,010
G.....	21.2%	65,720

The products sold are not sufficiently similar to allow for the definition of the arm's-length range in terms of all constructive operating profits. Therefore, the range is limited to those constructive operating profits that fall within the interquartile range of results. The appropriate range extends from \$22,010 to \$39,060. USS's average reported profits of \$18,200 fall outside this range. Therefore, reported profit for 1995 is restated as the median of the range, \$29,450. A section 482 allocation of \$11,250 is rendered by the District Director.

III.

EFFECTIVE DATES AND DATA SELECTION

The Temporary Regulations are intended to go into effect April 21, 1993.⁷⁶ The Temporary Regulations are to be retroactive with regard to the commensurate with income standards of section 482 for all tax years begin-

72. Temp. Treas. Reg. § 1.482-5T(d)(2)(ii) (1993).

73. *Id.*

74. *Id.*

75. See also Temp. Treas. Reg. § 1.482-5T(g)(Example No. 3) (1993).

76. 58 Fed. Reg. 5263 (1993).

ning after December 31, 1986 on transfers and licenses of intangibles.⁷⁷ However, these rules will not apply to transfers of intangible property made or licenses granted to foreign persons before November 17, 1985, or to others before August 17, 1986, provided that the property was in existence or owned by the taxpayer on such date.⁷⁸ In cases of retroactive application, taxpayers are required to follow reasonable rules applicable to commensurate with income standards consistent with the statute, including those set out in the Proposed Regulations. It is clear, moreover, that the CPM is such a rule.⁷⁹

The CPM is to be based on actual results, rather than projections, normally averaged over a three-year period treating the audited year as the last,⁸⁰ presumably to insulate the taxpayer against fluctuations occurring during the year of audit. Exceptions relating to the unavailability of reliable data from the relevant time period, unusual business cycles of the industries involved, or irregular life cycles of intangibles under review may dictate a different time period,⁸¹ although all data relating to the tested and controlled parties must come from identical periods unless the lack of reliable data would dictate otherwise.⁸² It is unclear whether the IRS will use the CPM on audits occurring prior to 1994. The examples cited in the Temporary Regulations⁸³ do not treat an audited year prior to 1994, which may imply that the IRS does not intend to apply the CPM on data of cross-border transactions for any year ending before 1992.

IV.

DIFFICULTIES IN APPLYING THE CPM RULES

Multinational firms must try to comply with the CPM rules or face serious consequences. Unfortunately, such taxpayers are faced with severe barriers to compliance since the new rules fail to address adequately various issues that, if not resolved in the final Regulations, could preclude the effective application of the CPM mechanism.

A. Issues of Data Utilization

The clearest deficiency with the new CPM rules is the assumption that reliable and accurate data relating to similarly situated taxpayers will be readily available to controlled taxpayers and the IRS alike. That assumption will surely prove wrong with respect to the body of publicly available data. Re-

77. Temp. Treas. Reg. § 1.482-1T(h) (1993).

78. *Id.*

79. *Id.*

80. Temp. Treas. Reg. § 1.482-5T(d)(1) (1993).

81. Temp. Treas. Reg. § 1.482-1T(d)(3)(v)(A) (1993).

82. Temp. Treas. Reg. § 1.482-1T(d)(3)(v)(A) (1993).

83. Temp. Treas. Reg. § 1.482-5T(g)(Examples Nos. 1-3) (1993). These examples discuss an audit of 1994 which is treated as the last of three years averaged together. The fact that 1992 data is used in the examples is the strongest indication that the Temporary Regulations may be applied retroactively.

strictions associated with available data bases may even render the CPM useless as a planning vehicle.

The problem of securing accurate data from the tax filings of potential comparable taxpayers is especially critical. The annual publications of Treasury's *Statistics of Income*⁸⁴ are not only bereft of the data needed to determine the tested party and the comparable parties within the same industry segment, but are aggregated in order to protect the taxpayer's identity. The statistics submerge the appropriate data regarding similarly situated international firms that controlled taxpayers need to construct the CPM.

Available data bases published by the U.S. Department of Commerce,⁸⁵ international agencies such as the International Fiscal Association⁸⁶ and the United Nations,⁸⁷ and various ministries of foreign governments⁸⁸ dealing with income reported by multinational companies on foreign investment are also provided on an aggregated basis. These sources would be as deficient as the U.S. Treasury statistics. Certain relevant financial data theoretically could be extrapolated from the published financial statements of publicly held multinational corporations. Although these data banks are widely available, it would still be extremely difficult, if not impossible, to draw information regarding specific subsidiaries or product lines from the summarized data. To be absolutely certain of acquiring accurate data, the controlled taxpayer would be placed in the untenable position of requesting proprietary and well-guarded information directly from uncontrolled taxpayers which appear to be similarly situated.

The new Regulations also err in the assumption that the requisite data will be available on a timely basis. Established data bases lag two to three

84. IRS, U.S. DEP'T OF THE TREAS., STATISTICS OF INCOME: CORPORATION INCOME TAX RETURNS, published annually, is the best source of published survey data drawn from actual corporate tax returns. This data base includes industry specific income numbers. In order to protect the confidentiality of each corporate filer, the sample excludes many large corporations, thereby potentially omitting from the data tax numbers relevant to similarly situated corporations for many large multinational corporations.

85. The U.S. Department of Commerce's Bureau of Economic Analysis periodically publishes several industry specific estimates of the performance of U.S. corporations in foreign nations. Much of the data is specific to each foreign nation. Industry specific results of foreign corporations operating in the United States are also available. Publications include the monthly editions of BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COM., SURVEY OF CURRENT BUSINESS (Bureau of Econ. Analysis, Jan., 1972 -), the annual editions of BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COM., U.S. DIRECT INVESTMENT ABROAD: OPERATIONS OF U.S. PARENT COMPANIES AND THEIR FOREIGN AFFILIATES (1983 -), and similar benchmark survey data collected every five years.

86. Current transfer-pricing rules are described in INT'L TAX CONG., CAHIERS DE DROIT FISCAL INT'L VOL. 60(B), ALLOCATION OF EXPENSES IN INTERNATIONAL ARM'S LENGTH TRANSACTIONS OF RELATED COMPANIES (1975).

87. The United Nations publishes monthly survey data on international investment in United Nations Statistical Office, Monthly Bulletin of Statistics.

88. The most complete data bases published by foreign governments include CENTRAL STAT. OFFICE, ECONOMIC TRENDS (1953 -)(U.K.); DEUTSCHES INSTITUT FÜR WIRTSCHAFTSFORSCHUNG, VIERTELJAHRESHEFTE ZUR WIRTSCHAFTSFORSCHUNG (1948 -); DOMINION BUREAU OF STAT., NATIONAL ACCOUNTS, INCOME AND EXPENDITURE (1975 -)(Can.), RES. & STAT. DEP'T, BANK OF JAPAN, ECONOMIC STATISTICS ANNUAL (1981 -).

years behind the current year. Subsequent data revisions would alter the initial calculation of the CPM estimates. Since the data must relate to actual operations during the year under examination, it is conceivable that a controlled multinational company will be required to file periodic amendments when either the initial or revised data become available.

It is also ambiguous whether the CPM is to be constructed from tax data or financial accounting data. The Temporary Regulations seem to want to have it both ways. The reported operating profit of the tested party is defined in terms of income determined according to U.S. tax rules.⁸⁹ The examples cited in the Proposed Regulations rely on data from tax returns,⁹⁰ yet the underlying assumption of financial ratios derived from asset categories clearly indicates a preference for the use of financial accounting data.⁹¹ The CPM rules seem unable to discern the critical differences between financial and tax accounting rules.

It is also unclear whether foreign financial and tax data must be restated to reflect prevailing U.S. accounting and tax standards. The use of data drawn from divergent accounting and tax rules can cause serious distortions that the Temporary Regulations do not take into account. The need for reliable data at every stage of calculating the CPM only exacerbates this ambiguity. Other accounting questions also remain unanswered. For example, in what currency must the data be stated and what conversion rates should be used?⁹²

B. Definitional Issues Within the CPM

The Proposed Regulations offer little concrete guidance as to which industry segment would apply in cases of divergent categories. If, for example, the appropriate industry segment has to be broadened due to problems of unsuitable data and four possible categories exist, the taxpayer has no firm

89. Temp. Treas. Reg. § 1.482-5T(f)(5) (1993).

90. Temp. Treas. Reg. § 1.482-5T(g)(Examples Nos. 1-3) (1993).

91. Prop. Treas. Reg. § 1.482-2(f)(6)(iii)(B)(5), 57 Fed. Reg. 3588 (1992), defined assets in terms of financial book values rather than adjusted bases derived from tax filings. No other term specifically defined in the Proposed Regulations is stated in terms of a clear preference between financial accounting or tax data. The Temporary Regulations fail to define this term and seem to ignore the entire problem associated with divergent accounting rules. The new rules allow, but do not require, the restatement of operating income whenever the data relating to the comparable parties is derived from financial statements rather than U.S. tax filings. See Temp. Treas. Reg. § 1.482-5T(f)(5) (1993). There is no provision for the restatement of asset values.

92. The Service's analysis of the Proposed Regulations suggests that balance sheet accounts be reflected in U.S. currency for licensees with that functional currency. For licensees with a different functional currency, the dollar book value of the assets could be valued using historical exchange rates for their balance sheet accounts and current exchange rates for their income statement accounts. No reference is made to the broader questions of multinational companies that are not licensees or taxpayers using a nonfunctional currency. See 57 Fed. Reg. 3577 (1992). The Temporary Regulations completely ignore the entire question of currency translation.

guidelines as to which category to choose. The same ambiguity would exist in cases where the data would support a narrower category.

The Proposed Regulations do not enunciate exact criteria for determining whether an uncontrolled taxpayer is in fact similar to the tested party. While the CPM rules recognize that "similar" does not imply "identical,"⁹³ their concept of similarity needs refinement. The sole factors listed relate to similarity of product type and function.⁹⁴ These criteria alone cannot reasonably be expected to define similarity. The rules ignore other relevant issues such as cost factors, marginal returns associated with size of production, managerial strategies, and socioeconomic environments of the foreign nations involved, all of which affect the comparability of transfer-pricing schemes.

Furthermore, the statistical techniques to be used are not clear. The examples appear to treat statistical judgment as a routine matter.⁹⁵ The precise use of statistical tests, however, is shrouded in mystery even though the appropriate PLIs,⁹⁶ the arm's-length range of the tested party,⁹⁷ and the adjustments to the data of the comparable parties⁹⁸ are all determined through advanced statistical techniques.

C. Conceptual Issues Associated With the CPM

The Temporary Regulations rest on the untenable notion that transferred assets are essentially homogeneous. In each instance, it is assumed that uncontrolled entities can be located which trade in similar products or use similar intangibles. Such an assumption may be reasonable in the case of tangible assets that are regularly traded on world markets. However, the new rules do not adequately reflect the inherent uniqueness of intangibles. The Temporary Regulations broaden the applicability of rules covering intangibles to include all sorts of organizational and manufacturing techniques that are unique to each firm.⁹⁹ Intangibles such as patents, trade names, trademarks, and copyrights must, by definition, be dissimilar in order to qual-

93. The flexibility of the new rules in this regard reflects the results of prior litigation. See *supra* note 21.

94. See Temp. Treas. Reg. § 1.482-5T(c)(1) (1993).

95. The examples cited in the Temporary Regulations treat complex situations in which the District Director is able to render simple judgments without giving any hint as to the statistical tests employed. This is illustrated by the example in which a U.S. subsidiary of a foreign corporation is comparable to nine domestic corporations. What statistical maneuvers the District Director performed to make this determination is not explained. Temp. Treas. Reg. § 1.482-5T(g)(Example No. 3) (1993) is vaguer still. In the case presented in example 3, the District Director determines that uncontrolled firms M and N are the best match for similar taxpayers in nation H. *Id.* The statistical measures used by the District Director to render such a decision, though critical to tax planning for controlled taxpayers, are entirely overlooked in the examples and indeed in the Temporary Regulations as a whole.

96. Temp. Treas. Reg. § 1.482-5T(e) (1993).

97. Temp. Treas. Reg. § 1.482-5T(d) (1993).

98. Temp. Treas. Reg. § 1.482-5T(c)(2) (1993).

99. For a listing of the various categories of intangible assets see Temp. Treas. Reg. § 1.482-4T(b) (1993).

ify for legal protection. The new regulations' requirement of fundamental similarity of function¹⁰⁰ not only prohibits objective quantification, but the resulting ambiguity will lead to continued litigation.

The new rules also assume that all property in a controlled transfer flows in one direction. In cases where controlled parties engage in reciprocal transfers of tangible property or where each party has significant self-developed intangible assets that materially enter into the controlled transaction, the determination of the appropriate tested party and its corresponding industry segment may prove particularly troublesome.

The Temporary Regulations also ignore the oligopolistic nature of taxpayers ordinarily subject to a section 482 audit. The IRS has noted that section 482 adjustments tend to affect large taxpayers.¹⁰¹ The result may be that for many large multinational corporations, no similarly situated uncontrolled taxpayers may exist for purposes of measuring size-related factors.

Nation-specific factors affecting cross-border transactions may prove to be a critical defect in the CPM rules. Business-related factors reflected in the CPM rules would vary across borders. For example, in the case of controlled sales by a U.S. corporation to its subsidiary in Mexico, would the appropriate uncontrolled party also have to export products to a Mexican firm? The examples in the Temporary Regulations discuss such a contingency: if the District Director is unable to locate a similarly situated taxpayer doing business in the same foreign country as the tested party, he may locate suitable uncontrolled taxpayers in other countries.¹⁰² Yet such a conclusion is based on the optimistic assumption that the socio-economic environment of the foreign nations are essentially homogeneous. How could a Peruvian or an Australian firm qualify as a suitable surrogate for a Mexican firm which must operate in a completely different business environment?

The CPM rules also ignore the fact that restrictions imposed by foreign law can preclude the application of section 482. How these restrictions

100. Temp. Treas. Reg. § 1.482-5T(c)(1) (1993).

101. In its statistical summary relating to I.R.C. § 482 audits conducted in 1982, the IRS noted that nearly 70% of all § 482 adjustments involved U.S. multinational corporations with over \$250 million in total assets. This group accounted for nearly 85% of the value of such adjustments. Study of International Cases Involving Section 482 of the Internal Revenue Code, 1984 at 28. See generally Guenter Shindler & David Henderson, *Intercorporate Transfer Pricing - 1985 Survey of Section 482 Audits*, 29 TAX NOTES 1171 (1985).

102. Temp. Treas. Reg. § 1.482-5T(g)(Example No. 3) (1993) deals with a U.S. widget manufacturer doing business in country H. The District Director is unable to ascertain information about suitable uncontrolled widget manufacturers in H. *Id.* However, he broadens his search and determines that companies operating in countries M and N are suitable comparable parties. *Id.* This example is little more than a rehashing of examples enumerated in the Proposed Regulations. Prop. Treas. Reg. § 1.482-2(f)(11) (Examples Nos. (6)(ii), (iii)), 57 Fed. Reg. 3590 (1992) deal with a controlled taxpayer in country H. Since reliable data from comparable country H companies is unavailable, companies performing similar functions in country M are used as uncontrolled taxpayers. Prop. Treas. Reg. § 1.482-2(f)(11)(Example No. 7), 57 Fed. Reg. 3594 (1992), extends this analysis to the case where no data relating to companies in country M is available either. In that case, U.S. companies were located that qualified as the appropriate uncontrolled taxpayers.

should be reflected in the CPM is ambiguous. The recent case of *Procter & Gamble Co. v. Commissioner*¹⁰³ dramatizes the problem. In that case, a U.S. manufacturer licensed various intangibles to its Swiss subsidiary which was required to pay royalties to the parent based on use of the intangibles by all subsidiaries. The Swiss corporation in turn sublicensed the intangibles to a wholly-owned Spanish subsidiary that paid no royalties, since Spanish law forbade such a payment to foreign shareholders. The IRS tried to circumvent the Spanish statute by reallocating royalty income to the Spanish firm. The Tax Court held that section 482 could not be utilized in cases where income distortions were the result of foreign law rather than the actions of the members of the controlled group.¹⁰⁴ The new Regulations do not address the degree to which foreign data used in determining the CPM must be adjusted to reflect the effects of foreign restrictions.

V.

POTENTIAL STEPS TO OPERATIONALIZE THE CPM RULES

The IRS may be forced to publish safe harbor rates to make the CPM rules operational, especially in the case of small businesses.¹⁰⁵ Published rates would theoretically increase both the efficacy and usefulness of the CPM. Most safe harbors would be used by multiplying the book value of the tested party by published financial ratios based on country-wide averages.

The Service's analysis of the Proposed Regulations cited one example: a safe harbor might be created by reference to a narrow interval of rates of return surrounding eleven percent, since the average ratio of operating income to assets from 1980-1989 was approximately eleven percent based on data from U.S. publicly held companies.¹⁰⁶

This example, however, underscores the peculiar difficulties associated with relying on safe harbor rates. If nationwide averages are utilized, the underlying assumption of similarity between tested and uncontrolled taxpayers would be forfeited. The safe harbor rates would then be drawn from parties that are not only dissimilar to the tested party but are not even uncontrolled. Matching narrowly defined rates of return to the wider variations of returns in the marketplace is another problem. Differences in relative asset values held by divergent taxpayers or shifting of assets among controlled taxpayers would also not be properly reflected in safe harbor rates.

The Temporary Regulations do provide for safe harbor rates but only in the case of small taxpayers. U.S. controlled taxpayers with annual sales of

103. 95 T.C. 323, 336 (1990). Similar results were reached in *Commissioner v. First Sec. Bank*, 405 U.S. 394, 400 (1972). The IRS had previously argued in *Rev. Rul. 82-45, 1982-1 C.B. 89*, that foreign law would be considered irrelevant in determining I.R.C. § 482 allocations.

104. *Procter & Gamble*, 95 T.C. at 338.

105. Safe harbor rates would be PLIs published by the IRS specific to each industry. As long as an international firm used the published PLIs, it would be treated as having satisfied the CPM.

106. 57 Fed. Reg. 3577 (1992).

less than ten million dollars¹⁰⁷ or similar taxpayers that engage in aggregate cross-border transactions with foreign controlled taxpayers of less than \$10 million annually,¹⁰⁸ may elect to determine aggregate taxable income from all controlled transactions by applying the appropriate PLI subsequently published in applicable revenue rulings by the IRS.¹⁰⁹ Although compliance with the safe harbor rates may eliminate the risks of noncompliance with section 482 rules, the results achieved under the safe harbor scheme may be inferior to those determined in the absence of the safe harbor rates.

Multinational firms may be forced to rely on advance pricing agreements which represent mutual agreements between the IRS and multinational firms on the validity of transfer-pricing schemes. This procedure allows taxpayers that are not the subject of a formal audit to reach an agreement with the IRS concerning an appropriate transfer-pricing methodology to be applied in a certain case.¹¹⁰ Given the adverse effects of misapplying the CPM, affected firms may often acquiesce to unfavorable agreements in order to secure a safe position.

VI.

CONCLUSION

The new CPM rules represent an effort to inject a degree of flexibility and objectivity into an area of tax law dominated by complex factors and seemingly endless litigation. They have also broken new ground by freeing the transfer-pricing regulations from the stranglehold of the comparative transaction approach. The flexibility of expressing acceptable profits from controlled transactions in terms of a range rather than a specific income level is especially laudatory.

The concept of a definitive range of acceptable profits, however, is desirable only if the method of calculation is reasonable. In this regard, the CPM rules still fall short since many of their underlying assumptions are impractical.

If the rules are judged in terms of their primary intent of providing transfer-pricing taxpayers with a level of reasonable certainty, then the underlying ambiguities of the rules render them a failure. The rules introduce a degree of economic and statistical sophistication that may appear reasonable in theory, but in practice renders them unworkable. Unless the final regulations address these issues, the CPM rules will do little more than frustrate a taxpayer's ability to establish a reasonable transfer-pricing scheme.

107. Temp. Treas. Reg. § 1.482-1T(f)(ii)(A) (1993).

108. *Id.*

109. Temp. Treas. Reg. § 1.482-1T(f)(1)(i) (1993).

110. Rev. Proc. 91-22, 1991-1 C.B. 526. The IRS had specifically requested public suggestions for coordinating advance pricing agreements with the Proposed Regulations. 57 Fed. Reg. 3577 (1992). Due to the favorable comments received, the IRS has specifically stated that advance pricing agreements will constitute an integral component of transfer pricing compliance under the Temporary Regulations. See 58 Fed. Reg. 5270-71 (1993).