agreement shall be binding on the parties except upon a showing of fraud, malfeasance, or misrepresentation of material fact.

[T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.481–5 Effective dates.

Sections 1.481–1, 1.481–2, 1.481–3, and 1.481–4 are effective for Consent Agreements signed on or after December 27, 1994. For Consent Agreements signed before December 27, 1994, see §§ 1.481–1, 1.481–2, 1.481–3, 1.481–4, and 1.481–5 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

[T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.482–0 Outline of regulations under 482.

This section contains major captions for §§ 1.482–1 through 1.482–8.

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(b) Arm's length standard.
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(ii) Selection of category of method applicable to transaction.
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(3) Residual profit split.
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(A) Allocate income to routine contributions.
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§ 1.482–7 Sharing of costs.

§ 1.482–8 Examples of the best method rule.

[T.D. 8552, 59 FR 34988, July 8, 1994, as amended by T.D. 8632, 60 FR 65557, Dec. 20, 1995; 61 FR 7157, Feb. 26, 1996; T.D. 8670, 61 FR 21956, May 13, 1996; T.D. 9088, 68 FR 51177, Aug. 26, 2003]

§ 1.482–1 Allocation of income and deductions among taxpayers.

(a) *In general*—(1) *Purpose and scope.* The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This § 1.482–1 sets forth general principles and guidelines to be followed under section 482. Section 1.482–2 provides rules for the determination of the true

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(2) *Authority to make allocations.* The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

(3) *Taxpayer's use of section 482.* If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. See §1.6662–6T(a)(2) or successor regulations.

(b) *Arm's length standard*—(1) *In general.* In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. See §1.482–1(d)(2) (Standard of comparability). Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in §1.482–1(c).

(2) *Arm's length methods*—(i) *Methods.* Sections 1.482–2 through 1.482–6 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result. Section 1.482–7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

(ii) *Selection of category of method applicable to transaction.* The methods listed in §1.482–2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly, the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result. But see §1.482–1(f)(2)(i) (Aggregation of transactions). In addition, other applicable provisions of the Code may affect the characterization of a transaction, and therefore affect the methods applicable under section 482. See for example section 467.

(c) *Best method rule*—(1) *In general.* The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. See §1.482–8 for examples of the application of the best method rule. See §1.482–7 for the applicable method in the case of a qualified cost sharing arrangement.

(2) *Determining the best method.* Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. These factors are explained in paragraphs (c)(2)(i), (ii), and (iii) of this section.

(i) *Comparability.* The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in §1.482–1(d)(3) (Factors for determining comparability), and after making adjustments for differences, as described in §1.482–1(d)(2) (Standard of comparability). As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced. In addition, if adjustments are made to increase the degree of comparability, the number, magnitude, and reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. See §1.482–3(b)(2)(ii)(A). An analysis will be relatively less reliable, however, as the uncontrolled transactions become less comparable to the controlled transaction.

(ii) *Data and assumptions.* Whether a method provides the most reliable measure of an arm's length result also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled transactions. These factors are discussed in paragraphs (c)(2)(ii) (A), (B), and (C) of this section.

(A) *Completeness and accuracy of data.* The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. For example, the completeness and accuracy of data will determine the extent to which it is possible to identify differences between the controlled and uncontrolled transactions, and the reliability of adjustments that are made to account for such differences. An analysis will be relatively more reliable as the completeness and accuracy of the data increases.

(B) *Reliability of assumptions.* All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable. For example, adjustments for differences in payment terms between controlled and uncontrolled transactions may be based on the assumption that at arm's length such differences would lead to price differences that reflect the time value of money. Although selection of the appropriate interest rate to use in making such adjustments involves some judgement, the economic analysis on which the assumption is based is relatively sound. Other assumptions may be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method.

(C) *Sensitivity of results to deficiencies in data and assumptions.* Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake the same or similar functions, employ similar resources, and bear similar risks is particularly important. Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income, and assets may be of particular importance. Therefore, a difference between the controlled and uncontrolled transactions for which an accurate adjustment cannot be made may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method analysis, while differences in product characteristics will ordinarily have a greater effect on a comparable uncontrolled price method analysis than on a comparable profits method analysis.

(iii) *Confirmation of results by another method.* If two or more methods produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

(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.

(2) *Standard of comparability.* In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must

be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this section, a material difference is one that would materially affect the measure of an arm's length result under the method being applied. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced. Generally, such adjustments must be made to the results of the uncontrolled comparable and must be based on commercial practices, economic principles, or statistical analyses. The extent and reliability of any adjustments will affect the relative reliability of the analysis. See §1.482–1(c)(1) (Best method rule). In any event, unadjusted industry average returns themselves cannot establish arm's length results.

(3) *Factors for determining comparability*. The comparability factors listed in §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 charged 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 §1.482–2(a) or other applicable provisions of the Internal Revenue Code or regulations.

(B) *Identifying contractual terms*—(*1*) *Written agreement.* The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (see, for example, § 1.482–4(f)(3) (Ownership of intangible property)). If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

(*2*) *No written agreement.* In the absence of a written agreement, the district director may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights (see, for example, § 1.482–4(f)(3) (Ownership of intangible property)). For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the district director may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it. See UCC 1–205. For example, unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods. See UCC 2–310.

(C) *Examples.* The following examples illustrate this paragraph (d)(3)(ii).

Example 1—Differences in volume. USP, a United States agricultural exporter, regularly buys transportation services from FSub, its foreign subsidiary, to ship its products from the United States to overseas markets. Although FSub occasionally provides transportation services to URA, an unrelated domestic corporation, URA accounts for only 10% of the gross revenues of FSub, and the remaining 90% of FSub's gross revenues are attributable to FSub's transactions with USP. In determining the degree of comparability between FSub's uncontrolled transaction with URA and its controlled transaction with USP, the difference in volumes involved in the two transactions and the regularity with which these services are provided must be taken into account if such difference would have a material effect on the price charged. Inability to make reliable adjustments for these differences would affect the reliability of the results derived from the uncontrolled transaction as a measure of the arm's length result.

Example 2— Reliability of adjustment for differences in volume. (i) FS manufactures product XX and sells that product to its parent corporation, P. FS also sells product XX to uncontrolled taxpayers at a price of $100 per unit. Except for the volume of each transaction, the sales to P and to uncontrolled taxpayers take place under substantially the same economic conditions and contractual terms. In uncontrolled transactions, FS offers a 2% discount for quantities of 20 per order, and a 5% discount for quantities of 100 per order. If P purchases product XX in quantities of 60 per order, in the absence of other reliable information, it may reasonably be concluded that the arm's length price to P would be $100, less a discount of 3.5%.

(ii) If P purchases product XX in quantities of 1,000 per order, a reliable estimate of the appropriate volume discount must be based on proper economic or statistical analysis, not necessarily a linear extrapolation from the 2% and 5% catalog discounts applicable to sales of 20 and 100 units, respectively.

Example 3— Contractual term imputed from economic substance. (i) USD, a United States corporation, is the exclusive distributor of products manufactured by FP, its foreign parent. The FP products are sold under a tradename that is not known in the United States. USD does not have an agreement with FP for the use of FP's tradename. For Years 1 through 6, USD bears marketing expenses promoting FP's tradename in the United States that are substantially above the level of such expenses incurred by comparable distributors in uncontrolled transactions. FP does not directly or indirectly reimburse USD for its marketing expenses. By Year 7, the FP tradename has become very well known in the market and commands a price premium. At this time, USD becomes a commission agent for FP.

(ii) In determining USD's arm's length result for Year 7, the district director considers the economic substance of the arrangements between USD and FP throughout the course of their relationship. It is unlikely that at arm's length, USD would incur these above-normal expenses without some assurance it could derive a benefit from these expenses. In this case, these expenditures indicate a course of conduct that is consistent with an agreement under which USD received a long-term right to use the FP tradename in the United States. Such conduct is inconsistent with the contractual arrangements between FP and USD under which USD was merely a distributor, and later a commission agent, for FP. Therefore, the district director may impute an agreement between USD and FP under which USD will retain an appropriate portion of the price premium attributable to the FP tradename.

(iii) *Risk*—(A) *Comparability*. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include—

(*1*) Market risks, including fluctuations in cost, demand, pricing, and inventory levels;

(*2*) Risks associated with the success or failure of research and development activities;

(*3*) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates;

(*4*) Credit and collection risks;

(*5*) Product liability risks; and

(*6*) General business risks related to the ownership of property, plant, and equipment.

(B) *Identification of taxpayer that bears risk*. In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the provisions of §1.482–1(d)(3)(ii)(B) (Identifying contractual terms). Thus, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance. In considering the economic substance of the transaction, the following facts are relevant—

(*1*) Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;

(*2*) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(*3*) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

(C) *Examples.* The following examples illustrate this paragraph (d)(3)(iii).

Example 1. FD, the wholly-owned foreign distributor of USM, a U.S. manufacturer, buys widgets from USM under a written contract. Widgets are a generic electronic appliance. Under the terms of the contract, FD must buy and take title to 20,000 widgets for each of the five years of the contract at a price of $10 per widget. The widgets will be sold under FD's label, and FD must finance any marketing strategies to promote sales in the foreign market. There are no rebate or buy back provisions. FD has adequate financial capacity to fund its obligations under the contract under any circumstances that could reasonably be expected to arise. In Years 1, 2 and 3, FD sold only 10,000 widgets at a price of $11 per unit. In Year 4, FD sold its entire inventory of widgets at a price of $25 per unit. Since the contractual terms allocating market risk were agreed to before the outcome of such risk was known or reasonably knowable, FD had the financial capacity to bear the market risk that it would be unable to sell all of the widgets it purchased currently, and its conduct was consistent over time, FD will be deemed to bear the risk.

Example 2. The facts are the same as in *Example 1*, except that in Year 1 FD had only $100,000 in total capital, including loans. In subsequent years USM makes no additional contributions to the capital of FD, and FD is unable to obtain any capital through loans from an unrelated party. Nonetheless, USM continues to sell 20,000 widgets annually to FD under the terms of the contract, and USM extends credit to FD to enable it to finance the purchase. FD does not have the financial capacity in Years 1, 2 and 3 to finance the purchase of the widgets given that it could not sell most of the widgets it purchased during those years. Thus, notwithstanding the terms of the contract, USM and not FD assumed the market risk that a substantial portion of the widgets could not be sold, since in that event FD would not be able to pay USM for all of the widgets it purchased.

Example 3. S, a Country X corporation, manufactures small motors that it sells to P, its U.S. parent. P incorporates the motors into various products and sells those products to uncontrolled customers in the United States. The contract price for the motors is expressed in U.S. dollars, effectively allocating the currency risk for these transactions to S for any currency fluctuations between the time the contract is signed and payment is made. As long as S has adequate financial capacity to bear this currency risk (including by hedging all or part of the risk) and the conduct of S and P is consistent with the terms of the contract (i.e., the contract price is not adjusted to reflect exchange rate movements), the agreement of the parties to allocate the exchange risk to S will be respected.

Example 4. USSub is the wholly-owned U.S. subsidiary of FP, a foreign manufacturer. USSub acts as a distributor of goods manufactured by FP. FP and USSub execute an agreement providing that FP will bear any ordinary product liability costs arising from defects in the goods manufactured by FP. In practice, however, when ordinary product liability claims are sustained against USSub and FP, USSub pays the resulting damages. Therefore, the district director disregards the contractual arrangement regarding product liability costs between FP and USSub, and treats the risk as having been assumed by USSub.

(iv) *Economic conditions.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include—

(A) The similarity of geographic markets;

(B) The relative size of each market, and the extent of the overall economic development in each market;

(C) The level of the market (e.g., wholesale, retail, etc.);

(D) The relevant market shares for the products, properties, or services transferred or provided;

(E) The location-specific costs of the factors of production and distribution;

(F) The extent of competition in each market with regard to the property or services under review;

(G) The economic condition of the particular industry, including whether the market is in contraction or expansion; and

(H) The alternatives realistically available to the buyer and seller.

(v) *Property or services.* Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangibles that are embedded in tangible property or services being transferred. The comparability of the embedded intangibles will be analyzed using the factors listed in § 1.482–4(c)(2)(iii)(B)(*1*) (Comparable intangible property). The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied. For guidance concerning the specific comparability considerations applicable to transfers of tangible and intangible property, see §§ 1.482–3 through 1.482–6; see also § 1.482–3(f), dealing with the coordination of the intangible and tangible property rules.

(4) *Special circumstances*—(i) *Market share strategy*. In certain circumstances, taxpayers may adopt strategies to enter new markets or to increase a product's share of an existing market (market share strategy). Such a strategy would be reflected by temporarily increased market development expenses or resale prices that are temporarily lower than the prices charged for comparable products in the same market. Whether or not the strategy is reflected in the transfer price depends on which party to the controlled transaction bears the costs of the pricing strategy. In any case, the effect of a market share strategy on a controlled transaction will be taken into account only if it can be shown that an uncontrolled taxpayer engaged

in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following—

(A) The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;

(B) The market share strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

(C) The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented.

(ii) *Different geographic markets*—(A) *In general.* Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, but the extent of such differences may affect the reliability of the method for purposes of the best method rule. For this purpose, a geographic market is any geographic area in which the economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions.

(B) *Example.* The following example illustrates this paragraph (d)(4)(ii).

Example. Manuco, a wholly-owned foreign subsidiary of P, a U.S. corporation, manufactures products in Country Z for sale to P. No uncontrolled transactions are located that would provide a reliable measure of the arm's length result under the comparable uncontrolled price method. The district director considers applying the cost plus method or the comparable profits method. Information on uncontrolled taxpayers performing comparable functions under comparable circumstances in the same geographic market is not available. Therefore, adjusted data from uncontrolled manufacturers in other markets may be considered in order to apply the cost plus method. In this case, comparable uncontrolled manufacturers are found in the United States. Accordingly, data from the comparable U.S. uncontrolled manufacturers, as adjusted to account for differences between the United States and Country Z's geographic market, is used to test the arm's length price paid by P to Manuco. However, the use of such data may affect the reliability of the results for purposes of the best method rule. See §1.482–1(c).

(C) *Location savings.* If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.

(D) *Example.* The following example illustrates the principles of this paragraph (d)(4)(ii)(C).

Example. Couture, a U.S. apparel design corporation, contracts with Sewco, its wholly owned Country Y subsidiary, to manufacture its clothes. Costs of operating in Country Y are significantly lower than the operating costs in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge that could not be acquired by actual or potential competitors to Sewco at reasonable cost. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco in geographic markets that are similar to Country Y. Thus, the fact that production is less costly in Country Y will not, in and of itself, justify additional profits derived from lower operating costs in Country Y inuring to Sewco, because the competitive positions of the other actual or potential producers in similar geographic markets capable of performing the same functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.

(iii) *Transactions ordinarily not accepted as comparables*—(A) *In general.* Transactions ordinarily will not constitute reliable measures of an arm's length result for purposes of this section if—

(*1*) They are not made in the ordinary course of business; or

(*2*) One of the principal purposes of the uncontrolled transaction was to establish an arm's length result with respect to the controlled transaction.

(B) *Examples.* The following examples illustrate the principle of this paragraph (d)(4)(iii).

Example 1 Not in the ordinary course of business. USP, a United States manufacturer of computer software, sells its products to FSub, its foreign distributor in country X. Compco, a United States competitor of USP, also sells its products in X through unrelated distributors. However, in the year under review, Compco is forced into bankruptcy, and Compco liquidates its inventory by selling all of its products to unrelated distributors in X for a liquidation price. Because the sale of its entire inventory was not a sale in the ordinary course of business, Compco's sale cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

Example 2 Principal purpose of establishing an arm's length result. USP, a United States manufacturer of farm machinery, sells its products to FSub, its wholly-owned distributor in Country Y. USP, operating at nearly full capacity, sells 95% of its inventory to FSub. To make use of its excess capacity, and also to establish a comparable uncontrolled price for its transfer price to FSub, USP increases its production to full capacity. USP sells its excess inventory to Compco, an unrelated foreign distributor in Country X. Country X has approximately the same economic conditions as that of Country Y. Because one of the principal purposes of selling to Compco was to establish an arm's length price for its controlled transactions with FSub, USP's sale to Compco cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

(e) *Arm's length range*—(1) *In general.* In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).

(2) *Determination of arm's length range*—(i) *Single method.* The arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability. Use of more than one method may be appropriate for the purposes described in paragraph (c)(2)(iii) of this section (Best method rule).

(ii) *Selection of comparables.* Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. See § 1.482–1(d)(2) (Standard of comparability). The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

(iii) *Comparables included in arm's length range*—(A) *In general.* The arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions: the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference.

(B) *Adjustment of range to increase reliability*. If there are no uncontrolled comparables described in paragraph (e)(2)(iii)(A) of this section, the arm's length range is derived from the results of all the uncontrolled comparables, selected pursuant to paragraph (e)(2)(ii) of this section, that achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables so selected. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.

(C) *Interquartile range.* For purposes of this section, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined analogously.

(3) *Adjustment if taxpayer's results are outside arm's length range.* If the results of a controlled transaction fall outside the arm's length range, the district director may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range. If the interquartile range is used to determine the arm's length range, such adjustment will ordinarily be to the median of all the results. The median is the 50th percentile of the results, which is determined in a manner analogous to that described in paragraph (e)(2)(iii)(C) of this section (Interquartile range). In other cases, an adjustment normally will be made to the arithmetic mean of all the results. See §1.482–1(f)(2)(iii)(D) for determination of an adjustment when a controlled taxpayer's result for a multiple year period falls outside an arm's length range consisting of the average results of uncontrolled comparables over the same period.

(4) *Arm's length range not prerequisite to allocation*. The rules of this paragraph (e) do not require that the district director establish an arm's length range prior to making an allocation under section 482. Thus, for example, the district director may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method, as described in §1.482–3(b), has been properly applied. However, if the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices in a manner consistent with the requirements set forth in §1.482–1(e)(2)(iii), then no allocation will be made.

(5) *Examples.* The following examples illustrate the principles of this paragraph (e).

Example 1 Selection of comparables. (i) To evaluate the arm's length result of a controlled transaction between USSub, the United States taxpayer under review, and FP, its foreign parent, the district director considers applying the resale price method. The district director identifies ten potential uncontrolled transactions. The distributors in all ten uncontrolled transactions purchase and resell similar products and perform similar functions to those of USSub.

(ii) Data with respect to three of the uncontrolled transactions is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these three uncontrolled comparables is significantly lower than that of the other seven. Further, of those seven, adjustments for the identified material differences can be reliably made for only four of the uncontrolled transactions. Therefore, pursuant to §1.482–1(e)(2)(ii) only these four uncontrolled comparables may be used to establish an arm's length range.

Example 2 Arm's length range consists of all the results. (i) The facts are the same as in *Example 1.* Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to §1.482-1(d)(2), the district director derives the following results:

Comparable	Result (price)
1	$44.00
2	45.00
3	45.00
4	45.50

(ii) The district director determines that data regarding the four uncontrolled transactions is sufficiently complete and accurate so that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, such differences have a definite and reasonably ascertainable effect, and appropriate adjustments were made for such differences. Accordingly, if the resale price method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction will consist of the results of all of the uncontrolled comparables, pursuant to paragraph (e)(2)(iii)(A) of this section. Thus, the arm's length range in this case would be the range from $44 to $45.50.

Example 3 Arm's length range limited to interquartile range. (i) The facts are the same as in *Example 2,* except in this case there are some product and functional differences between the four uncontrolled comparables and USSub. However, the data is insufficiently complete to determine the effect of the differences. Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to §1.482–1(d)(2), the district director derives the following results:

Uncontrolled comparable	Result (price)
1	$42.00
2	44.00
3	45.00
4	47.50

(ii) It cannot be established in this case that all material differences are likely to have been identified and reliable adjustments made for those differences. Accordingly, if the resale price method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction must be established pursuant to paragraph (e)(2)(iii)(B) of this section. In this case, the district director uses the interquartile range to determine the arm's length range, which is the range from $43 to $46.25. If USSub's price falls outside this range, the district director may make an allocation. In this case that allocation would be to the median of the results, or $44.50.

Example 4 Arm's length range limited to interquartile range. (i) To evaluate the arm's length result of controlled transactions between USP, a United States manufacturing company, and FSub, its foreign subsidiary, the district director considers applying the comparable profits method. The district director identifies 50 uncontrolled taxpayers within the same industry that potentially could be used to apply the method.

(ii) Further review indicates that only 20 of the uncontrolled manufacturers engage in activities requiring similar capital investments and technical know-how. Data with respect to five of the uncontrolled manufacturers is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these five uncontrolled comparables is significantly lower than that of the other 15. In addition, for those five uncontrolled comparables it is not possible to accurately allocate costs between the business activity associated with the relevant transactions and other business activities. Therefore, pursuant to §1.482–1(e)(2)(ii) only the other fifteen uncontrolled comparables may be used to establish an arm's length range.

(iii) Although the data for the fifteen remaining uncontrolled comparables is relatively complete and accurate, there is a significant possibility that some material differences may remain. The district director has determined, for example, that it is likely that there are material differences in the level of technical expertise or in management efficiency. Accordingly, if the comparable profits method is determined to be the best method pursuant to §1.482–1(c), the arm's length range for the controlled transaction may be established only pursuant to paragraph (e)(2)(iii)(B) of this section.

(f) *Scope of review*—(1) *In general.* The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm's length with an uncontrolled taxpayer.

(i) *Intent to evade or avoid tax not a prerequisite.* In making allocations under section 482, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

(ii) *Realization of income not a prerequisite*—(A) *In general.* The district director may make an allocation under section 482 even if the income ultimately anticipated from a series of transactions has not been or is never realized. For example, if a controlled taxpayer sells a product at less than an arm's length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first year. Similarly, if a controlled taxpayer lends money to a related taxpayer in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second controlled taxpayer does not realize income during such year. Finally, even if two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation under section 482 is not precluded.

(B) *Example.* The following example illustrates this paragraph (f)(1)(ii).

Example. USSub is a U.S. subsidiary of FP, a foreign corporation. Parent manufactures product X and sells it to USSub. USSub functions as a distributor of product X to unrelated customers in the United States. The fact that FP may incur a loss on the manufacture and sale of product X does not by itself establish that USSub, dealing with FP at arm's length, also would incur a loss. An independent distributor acting at arm's length with its supplier would in many circumstances be expected to earn a profit without regard to the level of profit earned by the supplier.

(iii) *Nonrecognition provisions may not bar allocation*—(A) *In general.* If necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031).

(B) *Example.* The following example illustrates this paragraph (f)(1)(iii).

Example. (i) In Year 1 USP, a United States corporation, bought 100 shares of UR, an unrelated corporation, for $100,000. In Year 2, when the value of the UR stock had decreased to $40,000, USP contributed all 100 shares of UR stock to its wholly-owned subsidiary in exchange for subsidiary's capital stock. In Year 3, the subsidiary sold all of the UR stock for $40,000 to an unrelated buyer, and on its U.S. income tax return, claimed a loss of $60,000 attributable to the sale of the UR stock. USP and its subsidiary do not file a consolidated return.

(ii) In determining the true taxable income of the subsidiary, the district director may disallow the loss of $60,000 on the ground that the loss was incurred by USP. *National Securities Corp. v Commissioner,* 137 F.2d 600 (3rd Cir. 1943), cert. denied, 320 U.S. 794 (1943).

(iv) *Consolidated returns.* Section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return.

(2) *Rules relating to determination of true taxable income.* The following rules must be taken into account in determining the true taxable income of a controlled taxpayer.

(i) *Aggregation of transactions*—(A) *In general.* The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in § 1.6038A–3(c)(7)(vii).

(B) *Examples.* The following examples illustrate this paragraph (f)(2)(i).

Example 1. P enters into a license agreement with S1, its subsidiary, that permits S1 to use a proprietary manufacturing process and to sell the output from this process throughout a specified region. S1 uses the manufacturing process and sells its output to S2, another subsidiary of P, which in turn resells the output to uncontrolled parties in the specified region. In evaluating the arm's length character of the royalty paid by S1 to P, it may be appropriate to consider the arm's length character of the transfer prices charged by S1 to S2 and the aggregate profits earned by S1 and S2 from the use of the manufacturing process and the sale to uncontrolled parties of the products produced by S1.

Example 2. S1, S2, and S3 are Country Z subsidiaries of U.S. manufacturer P. S1 is the exclusive Country Z distributor of computers manufactured by P. S2 provides marketing services in connection with sales of P computers in Country Z, and in this regard uses significant marketing intangibles provided by P. S3 administers the warranty program with respect to P computers in Country Z, including maintenance and repair services. In evaluating the arm's length character of the transfer price paid by S1 to P, of the fees paid by S2 to P for the use of P marketing intangibles, and of the service fees earned by S2 and S3, it may be appropriate to consider the combined effects of these separate transactions because they are so interrelated that they are most reliably analyzed on an aggregated basis.

Example 3. The facts are the same as in *Example 2.* In addition, U1, U2, and U3 are uncontrolled taxpayers that carry out functions comparable to those of S1, S2, and S3, respectively, with respect to computers produced by unrelated manufacturers. R1, R2, and R3 are a controlled group of taxpayers (unrelated to the P controlled group) that also carry out functions comparable to those of S1, S2, and S3 with respect to computers produced by their common parent. Prices charged to uncontrolled customers of the R group differ from the prices charged to customers of U1, U2, and U3. In determining whether the transactions of U1, U2, and U3, or the transactions of R1, R2, and R3 would provide a more reliable measure of the arm's length result, it is determined that the interrelated R group transactions are more reliable than the wholly independent transactions of U1, U2, and U3, given the interrelationship of the P group transactions.

Example 4. P enters into a license agreement with S1 that permits S1 to use a propriety process for manufacturing product X and to sell product X to uncontrolled parties throughout a specified region. P also sells to S1 product Y which is manufactured by P in the United States, and which is unrelated to product X. Product Y is resold by S1 to uncontrolled parties in the specified region. In evaluating the arm's length character of the royalty paid by S1 to P for the use of the manufacturing process for product X, and the transfer prices charged for unrelated product Y, it would not be appropriate to consider the combined effects of these separate and unrelated transactions.

(ii) *Allocation based on taxpayer's actual transactions*—(A) *In general.* The district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the district director may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the district director may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer. See § 1.482–1(d)(3) (Factors for determining comparability, Contractual terms and Risk); §§ 1.482–3(e) and 1.482–4(d) (Unspecified methods).

(B) *Example.* The following example illustrates this paragraph (f)(2)(ii).

Example. P and S are controlled taxpayers. P enters into a license agreement with S that permits S to use a proprietary process for manufacturing product X. Using its sales and marketing employees, S sells product X to related and unrelated customers outside the United States. If the license agreement between P and S has economic substance, the district director ordinarily will not restructure the taxpayer's transaction to treat P as if it had elected to exploit directly the manufacturing process. However, the fact that P could have manufactured product X may be taken into account under § 1.482–4(d) in determining the arm's length consideration for the controlled transaction. For an example of such an analysis, see *Example* in § 1.482–4(d)(2).

(iii) *Multiple year data*—(A) *In general.* The results of a controlled transaction ordinarily will be compared with the results of uncontrolled comparables occurring in the taxable year under review. It may be appropriate, however, to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. If data relating to uncontrolled comparables from multiple years is used, data relating to the controlled taxpayer for the same years ordinarily must be considered. However, if such data is not available, reliable data from other years, as adjusted under paragraph (d)(2) (Standard of comparability) of this section may be used.

(B) *Circumstances warranting consideration of multiple year data.* The extent to which it is appropriate to consider multiple-year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data is available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible being examined. Data from one or more years before or after the taxable year under review must ordinarily be considered for purposes of applying the provisions of §1.482–1(d)(3)(iii) (Risk), §1.482–1(d)(4)(i) (Market share strategy), §1.482–4(f)(2) (Periodic adjustments), and §1.482–5 (Comparable profits method). On the other hand, multiple-year data ordinarily will not be considered for purposes of applying the comparable uncontrolled price method (except to the extent that risk or market share strategy issues are present).

(C) *Comparable effect over comparable period.* Data from multiple years may be considered to determine whether the same economic conditions that caused the controlled taxpayer's results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm's length range. For example, given that uncontrolled taxpayers enter into transactions with the ultimate expectation of earning a profit, persistent losses among controlled taxpayers may be an indication of non-arm's length dealings. Thus, if a controlled taxpayer that realizes a loss with respect to a controlled transaction seeks to demonstrate that the loss is within the arm's length range, the district director may take into account data from taxable years other than the taxable year of the transaction to determine whether the loss was attributable to arm's length dealings. The rule of this paragraph (f)(2)(iii)(C) is illustrated by *Example 3* of paragraph (f)(2)(iii)(E) of this section.

(D) *Applications of methods using multiple year averages.* If a comparison of a controlled taxpayer's average result over a multiple year period with the average results of uncontrolled comparables over the same period would reduce the effect of short-term variations that may be unrelated to transfer pricing, it may be appropriate to establish a range derived from the average results of uncontrolled comparables over a multiple year period to determine if an adjustment should be made. In such a case the district director may make an adjustment if the controlled taxpayer's average result for the multiple year period is not within such range. Such a range must be determined in accordance with §1.482–1(e) (Arm's length range). An adjustment in such a case ordinarily will be equal to the difference, if any, between the controlled taxpayer's result for the taxable year and the mid-point of the uncontrolled comparables' results for that year. If the interquartile range is used to determine the range of average results for the multiple year period, such adjustment will ordinarily be made to the median of all the results of the uncontrolled comparables for the taxable year. See *Example 2* of §1.482–5(e). In other cases, the adjustment normally will be made to the arithmetic mean of all the results of the uncontrolled comparables for the taxable year. However, an adjustment will be made only to the extent that it would move the controlled taxpayer's multiple year average closer to the arm's length range for the multiple year period or to any point within such range. In determining a controlled taxpayer's average result for a multiple year period, adjustments made under this section for prior years will be taken into account only if such adjustments have been finally determined, as described in § 1.482–1(g)(2)(iii). See *Example 3* of § 1.482–5(e).

(E) *Examples.* The following examples, in which S and P are controlled taxpayers, illustrate this paragraph (f)(2)(iii). *Examples 1* and *4* also illustrate the principle of the arm's length range of paragraph (e) of this section.

Example 1. P sold product Z to S for $60 per unit in 1995. Applying the resale price method to data from uncontrolled comparables for the same year establishes an arm's length range of prices for the controlled transaction from $52 to $59 per unit. Since the price charged in the controlled transaction falls outside the range, the district director would ordinarily make an allocation under section 482. However, in this case there are cyclical factors that affect the results of the uncontrolled comparables (and that of the controlled transaction) that cannot be adequately accounted for by specific adjustments to the data for 1995. Therefore, the district director considers results over multiple years to account for these factors. Under these circumstances, it is appropriate to average the results of the uncontrolled comparables over the years 1993, 1994, and 1995 to determine an arm's length range. The averaged results establish an arm's length range of $56 to $58 per unit. For consistency, the results of the controlled taxpayers must also be averaged over the same years. The average price in the controlled transaction over the three years is $57. Because the controlled transfer price of product Z falls within the arm's length range, the district director makes no allocation.

Example 2. (i) FP, a Country X corporation, designs and manufactures machinery in Country X. FP's costs are incurred in Country X currency. USSub is the exclusive distributor of FP's machinery in the United States. The price of the machinery sold by FP to USSub is expressed in Country X currency. Thus, USSub bears all of the currency risk associated with fluctuations in the exchange rate between the time the contract is signed and the payment is made. The prices charged by FP to USSub for 1995 are under examination. In that year, the value of the dollar depreciated against the currency of Country X, and as a result, USSub's gross margin was only 8%.

(ii) UD is an uncontrolled distributor of similar machinery that performs distribution functions substantially the same as those performed by USSub, except that UD purchases and resells machinery in transactions where both the purchase and resale prices are denominated in U.S. dollars. Thus, UD had no currency exchange risk. UD's gross margin in 1995 was 10%. UD's average gross margin for the period 1990 to 1998 has been 12%.

(iii) In determining whether the price charged by FP to USSub in 1995 was arm's length, the district director may consider USSub's average gross margin for an appropriate period before and after 1995 to determine whether USSub's average gross margin during the period was sufficiently greater than UD's average gross margin during the same period such that USSub was sufficiently compensated for the currency risk it bore throughout the period. See § 1.482-1(d)(3)(iii) (Risk).

Example 3. FP manufactures product X in Country M and sells it to USSub, which distributes X in the United States. USSub realizes losses with respect to the controlled transactions in each of five consecutive taxable years. In each of the five consecutive years a different uncontrolled comparable realized a loss with respect to comparable transactions equal to or greater than USSub's loss. Pursuant to paragraph (f)(3)(iii)(C) of this section, the district director examines whether the uncontrolled comparables realized similar losses over a comparable period of time, and finds that each of the five comparables realized losses in only one of the five years, and their average result over the five-year period was a profit. Based on this data, the district director may conclude that the controlled taxpayer's results are not within the arm's length range over the five year period, since the economic conditions that resulted in the controlled taxpayer's loss did not have a comparable effect over a comparable period of time on the uncontrolled comparables.

Example 4. (i) USP, a U.S. corporation, manufactures product Y in the United States and sells it to FSub, which acts as USP's exclusive distributor of product Y in Country N. The resale price method described in § 1.482–3(c) is used to evaluate whether the transfer price charged by USP to FSub for the 1994 taxable year for product Y was arm's length. For the period 1992 through 1994, FSub had a gross profit margin for each year of 13%. A, B, C and D are uncontrolled distributors of products that compete directly with product Y in country N. After making appropriate adjustments in accordance with §§ 1.482–1(d)(2) and 1.482–3(c), the gross profit margins for A, B, C, and D are as follows:

	1992	1993	1994	Average
A	13	3	8	8.00
B	11	13	2	8.67
7C	4	7	13	8.00
7D	7	9	6	7.33

(ii) Applying the provisions of § 1.482–1(e), the district director determines that the arm's length range of the average gross profit margins is between 7.33 and 8.67. The district director concludes that FSub's average gross margin of 13% is not within the arm's length range, despite the fact that C's gross profit margin for 1994 was also 13%, since the economic conditions that caused S's result did not have a comparable effect over a comparable period of time on the results of C or the other uncontrolled comparables. In this case, the district director makes an allocation equivalent to adjusting FSub's gross profit margin for 1994 from 13% to the mean of the uncontrolled comparables' results for 1994 (7.25%).

(iv) *Product lines and statistical techniques.* The methods described in §§1.482–2 through 1.482–6 are generally stated in terms of individual transactions. However, because a taxpayer may have controlled transactions involving many different products, or many separate transactions involving the same product, it may be impractical to analyze every individual transaction to determine its arm's length price. In such cases, it is permissible to evaluate the arm's length results by applying the appropriate methods to the overall results for product lines or other groupings. In addition, the arm's length results of all related party transactions entered into by a controlled taxpayer may be evaluated by employing sampling and other valid statistical techniques.

(v) *Allocations apply to results, not methods*—(A) *In general.* In evaluating whether the result of a controlled transaction is arm's length, it is not necessary for the district director to determine whether the method or procedure that a controlled taxpayer employs to set the terms for its controlled transactions corresponds to the method or procedure that might have been used by a taxpayer dealing at arm's length with an uncontrolled taxpayer. Rather, the district director will evaluate the result achieved rather than the method the taxpayer used to determine its prices.

(B) *Example.* The following example illustrates this paragraph (f)(2)(v).

Example. (i) FS is a foreign subsidiary of P, a U.S. corporation. P manufactures and sells household appliances. FS operates as P's exclusive distributor in Europe. P annually establishes the price for each of its appliances sold to FS as part of its annual budgeting, production allocation and scheduling, and performance evaluation processes. FS's aggregate gross margin earned in its distribution business is 18%.

(ii) ED is an uncontrolled European distributor of competing household appliances. After adjusting for minor differences in the level of inventory, volume of sales, and warranty programs conducted by FS and ED, ED's aggregate gross margin is also 18%. Thus, the district director may conclude that the aggregate prices charged by P for its appliances sold to FS are arm's length, without determining whether the budgeting, production, and performance evaluation processes of P are similar to such processes used by ED.

(g) *Collateral adjustments with respect to allocations under section 482*—(1) *In general.* The district director will take into account appropriate collateral adjustments with respect to allocations under section 482. Appropriate collateral adjustments may include correlative allocations, conforming adjustments, and setoffs, as described in this paragraph (g).

(2) *Correlative allocations*—(i) *In general.* When the district director makes an allocation under section 482 (referred to in this paragraph (g)(2) as the primary allocation), appropriate correlative allocations will also be made with respect to any other member of the group affected by the allocation. Thus, if the district director makes an allocation of income, the district director will not only increase the income of one member of the group, but correspondingly decrease the income of the other member. In addition, where appropriate, the district director may make such further correlative allocations as may be required by the initial correlative allocation.

(ii) *Manner of carrying out correlative allocation.* The district director will furnish to the taxpayer with respect to which the primary allocation is made a written statement of the amount and nature of the correlative allocation. The correlative allocation must be reflected in the documentation of the other member of the group that is maintained for U.S. tax purposes, without regard to whether it affects the U.S. income tax liability of the other member for any open year. In some circumstances the allocation will have an immediate U.S. tax effect, by changing the taxable income computation of the other member (or the taxable income computation of a shareholder of the other member, for example, under the provisions of subpart F of the Internal Revenue Code). Alternatively, the correlative allocation may not be reflected on any U.S. tax return until a later year, for example when a dividend is paid.

(iii) *Events triggering correlative allocation.* For purposes of this paragraph (g)(2), a primary allocation will not be considered to have been made (and therefore, correlative allocations are not required to be made) until the date of a final determination with respect to the allocation under section 482. For this purpose, a final determination includes—

(A) Assessment of tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such allocation;

(B) Acceptance of a Form 870–AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(C) Payment of the deficiency;

(D) Stipulation in the Tax Court of the United States; or

(E) Final determination of tax liability by offer-in-compromise, closing agreement, or final resolution (determined under the principles of section 7481) of a judicial proceeding.

(iv) *Examples.* The following examples illustrate this paragraph (g)(2). In each example, X and Y are members of the same group of controlled taxpayers and each regularly computes its income on a calendar year basis.

Example 1. (i) In 1996, Y, a U.S. corporation, rents a building owned by X, also a U.S. corporation. In 1998 the district director determines that Y did not pay an arm's length rental charge. The district director proposes to increase X's income to reflect an arm's length rental charge. X consents to the assessment reflecting such adjustment by executing Form 870, a Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment. The assessment of the tax with respect to the adjustment is made in 1998. Thus, the primary allocation, as defined in paragraph (g)(2)(i) of this section, is considered to have been made in 1998.

(ii) The adjustment made to X's income under section 482 requires a correlative allocation with respect to Y's income. The district director notifies X in writing of the amount and nature of the adjustment made with respect to Y. Y had net operating losses in 1993, 1994, 1995, 1996, and 1997. Although a correlative adjustment will not have an effect on Y's U.S. income tax liability for 1996, an adjustment increasing Y's net operating loss for 1996 will be made for purposes of determining Y's U.S. income tax liability for 1998 or a later taxable year to which the increased net operating loss may be carried.

Example 2. (i) In 1995, X, a U.S. construction company, provided engineering services to Y, a U.S. corporation, in the construction of Y's factory. In 1997, the district director determines that the fees paid by Y to X for its services were not arm's length and proposes to make an adjustment to the income of X. X consents to an assessment reflecting such adjustment by executing Form 870. An assessment of the tax with respect to such adjustment is made in 1997. The district director notifies X in writing of the amount and nature of the adjustment to be made with respect to Y.

(ii) The fees paid by Y for X's engineering services properly constitute a capital expenditure. Y does not place the factory into service until 1998. Therefore, a correlative adjustment increasing Y's basis in the factory does not affect Y's U.S. income tax liability for 1997. However, the correlative adjustment must be made in the books and records maintained by Y for its U.S. income tax purposes and such adjustment will be taken into account in computing Y's allowable depreciation or gain or loss on a subsequent disposition of the factory.

Example 3. In 1995, X, a U.S. corporation, makes a loan to Y, its foreign subsidiary not engaged in a U.S. trade or business. In 1997, the district director, upon determining that the interest charged on the loan was not arm's length, proposes to adjust X's income to reflect an arm's length interest rate. X consents to an assessment reflecting such allocation by executing Form 870, and an assessment of the tax with respect to the section 482 allocation is made in 1997. The district director notifies X in writing of the amount and nature of the correlative allocation to be made with respect to Y. Although the correlative adjustment does not have an effect on Y's U.S. income tax liability, the adjustment must be reflected in the documentation of Y that is maintained for U.S. tax purposes. Thus, the adjustment must be reflected in the determination of the amount of Y's earnings and profits for 1995 and subsequent years, and the adjustment must be made to the extent it has an effect on any person's U.S. income tax liability for any taxable year.

(3) *Adjustments to conform accounts to reflect section 482 allocations*—(i) *In general.* Appropriate adjustments must be made to conform a taxpayer's accounts to reflect allocations made under section 482. Such adjustments may include the treatment of an allocated amount as a dividend or a capital contribution (as appropriate), or, in appropriate cases, pursuant to such applicable revenue procedures as may be provided by the Commissioner (see § 601.601(d)(2) of this chapter), repayment of the allocated amount without further income tax consequences.

(ii) *Example.* The following example illustrates the principles of this paragraph (g)(3).

Example Conforming cash accounts. (i) USD, a United States corporation, buys Product from its foreign parent, FP. In reviewing USD's income tax return, the district director determines that the arm's length price would have increased USD's taxable income by $5 million. The district director accordingly adjusts USD's income to reflect its true taxable income.

(ii) To conform its cash accounts to reflect the section 482 allocation made by the district director, USD applies for relief under Rev. Proc. 65–17, 1965–1 C.B. 833 (see § 601.601(d)(2)(ii)(*b*) of this chapter), to treat the $5 million adjustment as an account receivable from FP, due as of the last day of the year of the transaction, with interest accruing therefrom.

(4) *Setoffs*—(i) *In general.* If an allocation is made under section 482 with respect to a transaction between controlled taxpayers, the district director will also take into account the effect of any other non-arm's length transaction between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation. Such setoff, however, will be taken into account only if the requirements of § 1.482–1(g)(4)(ii) are satisfied. If the effect of the setoff is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the U.S. tax liability of any member, adjustments will be made to reflect the correct amount of each category of income or deductions. For purposes of this setoff provision, the term arm's length refers to the amount defined in paragraph (b) (Arm's length standard) of this section, without regard to the rules in § 1.482–2 under which certain charges are deemed to be equal to arm's length.

(ii) *Requirements.* The district director will take a setoff into account only if the taxpayer—

(A) Establishes that the transaction that is the basis of the setoff was not at arm's length and the amount of the appropriate arm's length charge;

(B) Documents, pursuant to paragraph (g)(2) of this section, all correlative adjustments resulting from the proposed setoff; and

(C) Notifies the district director of the basis of any claimed setoff within 30 days after the earlier of the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or the date of the issuance of the notice of deficiency.

(iii) *Examples.* The following examples illustrate this paragraph (g)(4).

Example 1. P, a U.S. corporation, renders services to S, its foreign subsidiary in Country Y, in connection with the construction of S's factory. An arm's length charge for such services determined under § 1.482–2(b) would be $100,000. During the same taxable year P makes available to S the use of a machine to be used in the construction of the factory, and the arm's length rental value of the machine is $25,000. P bills S $125,000 for the services, but does not charge S for the use of the machine. No allocation will be made with respect to the undercharge for the machine if P notifies the district director of the basis of the claimed setoff within 30 days after the date of the letter from the district director transmitting the examination report notifying P of the proposed adjustment, establishes that the excess amount charged for services was equal to an arm's length charge for the use of the machine and that the taxable income and income tax liabilities of P are not distorted, and documents the correlative allocations resulting from the proposed setoff.

Example 2. The facts are the same as in *Example 1,* except that, if P had reported $25,000 as rental income and $25,000 less as service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(h) *Special rules*—(1) *Small taxpayer safe harbor.* [Reserved]

(2) *Effect of foreign legal restrictions*—(i) *In general.* The district director will

take into account the effect of a foreign legal restriction to the extent that such restriction affects the results of transactions at arm's length. Thus, a foreign legal restriction will be taken into account only to the extent that it is shown that the restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. In the absence of evidence indicating the effect of the foreign legal restriction on uncontrolled taxpayers, the restriction will be taken into account only to the extent provided in paragraphs (h)(2) (iii) and (iv) of this section (Deferred income method of accounting).

(ii) *Applicable legal restrictions.* Foreign legal restrictions (whether temporary or permanent) will be taken into account for purposes of this paragraph (h)(2) only if, and so long as, the conditions set forth in paragraphs (h)(2)(ii) (A) through (D) of this section are met.

(A) The restrictions are publicly promulgated, generally applicable to all similarly situated persons (both controlled and uncontrolled), and not imposed as part of a commercial transaction between the taxpayer and the foreign sovereign;

(B) The taxpayer (or other member of the controlled group with respect to which the restrictions apply) has exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of such restrictions (other than remedies that would have a negligible prospect of success if pursued);

(C) The restrictions expressly prevented the payment or receipt, in any form, of part or all of the arm's length amount that would otherwise be required under section 482 (for example, a restriction that applies only to the deductibility of an expense for tax purposes is not a restriction on payment or receipt for this purpose); and

(D) The related parties subject to the restriction did not engage in any arrangement with controlled or uncontrolled parties that had the effect of circumventing the restriction, and have not otherwise violated the restriction in any material respect.

(iii) *Requirement for electing the deferred income method of accounting.* If a foreign legal restriction prevents the payment or receipt of part or all of the arm's length amount that is due with respect to a controlled transaction, the restricted amount may be treated as deferrable if the following requirements are met—

(A) The controlled taxpayer establishes to the satisfaction of the district director that the payment or receipt of the arm's length amount was prevented because of a foreign legal restriction and circumstances described in paragraph (h)(2)(ii) of this section; and

(B) The controlled taxpayer whose U.S. tax liability may be affected by the foreign legal restriction elects the deferred income method of accounting, as described in paragraph (h)(2)(iv) of this section, on a written statement attached to a timely U.S. income tax return (or an amended return) filed before the IRS first contacts any member of the controlled group concerning an examination of the return for the taxable year to which the foreign legal restriction applies. A written statement furnished by a taxpayer subject to the Coordinated Examination Program will be considered an amended return for purposes of this paragraph (h)(2)(iii)(B) if it satisfies the requirements of a qualified amended return for purposes of § 1.6664–2(c)(3) as set forth in those regulations or as the Commissioner may prescribe by applicable revenue procedures. The election statement must identify the affected transactions, the parties to the transactions, and the applicable foreign legal restrictions.

(iv) *Deferred income method of accounting.* If the requirements of paragraph (h)(2)(ii) of this section are satisfied, any portion of the arm's length amount, the payment or receipt of which is prevented because of applicable foreign legal restrictions, will be treated as deferrable until payment or receipt of the relevant item ceases to be prevented by the foreign legal restriction. For purposes of the deferred income method of accounting under this paragraph (h)(2)(iv), deductions (including the cost or other basis of inventory and other assets sold or exchanged) and credits properly chargeable against any amount so deferred, are subject to deferral under the provisions of § 1.461- 1(a)(4). In addition, income is deferrable under this deferred income method of accounting only to the extent that it exceeds the related deductions already claimed in open taxable years to which the foreign legal restriction applied.

(v) *Examples.* The following examples, in which Sub is a Country FC subsidiary of U.S. corporation, Parent, illustrate this paragraph (h)(2).

Example 1. Parent licenses an intangible to Sub. FC law generally prohibits payments by any person within FC to recipients outside the country. The FC law meets the requirements of paragraph (h)(2)(ii) of this section. There is no evidence of unrelated parties entering into transactions under comparable circumstances for a comparable period of time, and the foreign legal restrictions will not be taken into account in determining the arm's length amount. The arm's length royalty rate for the use of the intangible property in the absence of the foreign restriction is 10% of Sub's sales in country FC. However, because the requirements of paragraph (h)(2)(ii) of this section are satisfied, Parent can elect the deferred income method of accounting by attaching to its timely filed U.S. income tax return a written statement that satisfies the requirements of paragraph (h)(2)(iii)(B) of this section.

Example 2. (i) The facts are the same as in *Example 1,* except that Sub, although it makes no royalty payment to Parent, arranges with an unrelated intermediary to make payments equal to an arm's length amount on its behalf to Parent.

(ii) The district director makes an allocation of royalty income to Parent, based on the arm's length royalty rate of 10%. Further, the district director determines that because the arrangement with the third party had the effect of circumventing the FC law, the requirements of paragraph (h)(2)(ii)(D) of this section are not satisfied. Thus, Parent could not validly elect the deferred income method of accounting, and the allocation of royalty income cannot be treated as deferrable. In appropriate circumstances, the district director may permit the amount of the distribution to be treated as payment by Sub of the royalty allocated to Parent, under the provisions of § 1.482–1(g) (Collateral adjustments).

Example 3. The facts are the same as in *Example 1,* except that the laws of FC do not prevent distributions from corporations to their shareholders. Sub distributes an amount equal to 8% of its sales in country FC. Because the laws of FC did not expressly prevent all forms of payment from Sub to Parent, Parent cannot validly elect the deferred income method of accounting with respect to any of the arm's length royalty amount. In appropriate circumstances, the district director may permit the 8% that was distributed to be treated as payment by Sub of the royalty allocated to Parent, under the provisions of § 1.482–1(g) (Collateral adjustments).

Example 4. The facts are the same as in *Example 1,* except that Country FC law permits the payment of a royalty, but limits the amount to 5% of sales, and Sub pays the 5% royalty to Parent. Parent demonstrates the existence of a comparable uncontrolled transaction for purposes of the comparable uncontrolled transaction method in which an uncontrolled party accepted a royalty rate of 5%. Given the evidence of the comparable uncontrolled transaction, the 5% royalty rate is determined to be the arm's length royalty rate.

(3) *Coordination with section 936*—(i) *Cost sharing under section 936.* If a possessions corporation makes an election under section 936(h)(5)(C)(i)(I), the corporation must make a section 936 cost sharing payment that is at least equal to the payment that would be required under section 482 if the electing corporation were a foreign corporation. In determining the payment that would be required under section 482 for this purpose, the provisions of §§ 1.482–1 and 1.482–4 will be applied, and to the extent relevant to the valuation of intangibles, §§ 1.482–5 and 1.482–6 will be applied. The provisions of section 936(h)(5)(C)(i)(II) (Effect of Election—electing corporation treated as owner of intangible property) do not apply until the payment that would be required under section 482 has been determined.

(ii) *Use of terms.* A cost sharing payment, for the purposes of section 936(h)(5)(C)(i)(I), is calculated using the provisions of section 936 and the regulations thereunder and the provisions of this paragraph (h)(3). The provisions relating to cost sharing under section 482 do not apply to payments made pursuant to an election under section 936(h)(5)(C)(i)(I). Similarly, a profit split payment, for the purposes of section 936(h)(5)(C)(ii)(I), is calculated using the provisions of section 936 and the regulations thereunder, not section 482 and the regulations thereunder.

(i) *Definitions.* The definitions set forth in paragraphs (i) (1) through (10) of this section apply to §§ 1.482–1 through 1.482–8.

(1) *Organization* includes an organization of any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place of organization, operation, or conduct of the trade or business, and regardless of whether it is a domestic or foreign organization, whether it is an exempt organization, or whether it is a member of an affiliated group that files a consolidated U.S. income tax return, or a member of an affiliated group that does not file a consolidated U.S. income tax return.

(2) *Trade* or *business* includes a trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place of operation. Employment for compensation will constitute a separate trade or business from the employing trade or business.

(3) *Taxpayer* means any person, organization, trade or business, whether or not subject to any internal revenue tax.

(4) *Controlled* includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(5) *Controlled taxpayer* means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. *Uncontrolled taxpayer* means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.

(6) *Group, controlled group,* and *group of controlled taxpayers* mean the taxpayers owned or controlled directly or indirectly by the same interests.

(7) *Transaction* means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer.

(8) *Controlled transaction* or *controlled transfer* means any transaction or transfer between two or more members of the same group of controlled taxpayers. The term *uncontrolled transaction* means any transaction between two or more taxpayers that are not members of the same group of controlled taxpayers.

(9) *True taxable income* means, in the case of a controlled taxpayer, the taxable income that would have resulted had it dealt with the other member or members of the group at arm's length. It does not mean the taxable income resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement the controlled taxpayer chose to make (even though such contract, transaction, or arrangement is legally binding upon the parties thereto).

(10) *Uncontrolled comparable* means the uncontrolled transaction or uncontrolled taxpayer that is compared with a controlled transaction or taxpayer under any applicable pricing methodology. Thus, for example, under the comparable profits method, an uncontrolled comparable is any uncontrolled taxpayer from which data is used to establish a comparable operating profit.

(j) *Effective dates*—(1) The regulations in this are generally effective for taxable years beginning after October 6, 1994.

(2) Taxpayers may elect to apply retroactively all of the provisions of these regulations for any open taxable year. Such election will be effective for the year of the election and all subsequent taxable years.

(3) Although these regulations are generally effective for taxable years as stated, the final sentence of section 482 (requiring that the income with respect to transfers or licenses of intangible property be commensurate with the income attributable to the intangible) is generally effective for taxable years beginning after December 31, 1986. For

the period prior to the effective date of these regulations, the final sentence of section 482 must be applied using any reasonable method not inconsistent with the statute. The IRS considers a method that applies these regulations or their general principles to be a reasonable method.

(4) These regulations will not apply with respect to transfers made or licenses granted to foreign persons before November 17, 1985, or before August 17, 1986, for transfers or licenses to others. Nevertheless, they will apply with respect to transfers or licenses before such dates if, with respect to property transferred pursuant to an earlier and continuing transfer agreement, such property was not in existence or owned by the taxpayer on such date.

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of § 1.482–5 apply for taxable years beginning on or after August 26, 2003.

[T.D. 8552, 59 FR 34990, July 8, 1994, as amended by T.D. 9088, 68 FR 51177, Aug. 26, 2003]

§ 1.482–2 Determination of taxable income in specific situations.

(a) *Loans or advances*—(1) *Interest on bona fide indebtedness*—(i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

(ii) *Application of paragraph (a) of this section*—(A) *Interest on bona fide indebtedness.* Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including—

(*1*) Loans or advances of money or other consideration (whether or not evidenced by a written instrument); and

(*2*) Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

(B) *Alleged indebtedness.* This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness, even if the stated rate of interest thereon would be within the safe haven rates prescribed in paragraph (a)(2)(iii) of this section. For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Similarly, this paragraph (a) does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property. Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. See § 1.482–2(a)(3)(i).

(iii) *Period for which interest shall be charged*—(A) *General rule.* This paragraph (a)(1)(iii) is effective for indebtedness arising after June 30, 1988. See § 1.482–2(a)(3) (26 CFR Part 1 edition revised as of April 1, 1988) for indebtedness arising before July 1, 1988. Except as otherwise provided in paragraphs (a)(1)(iii)(B) through (E) of this section, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise). Paragraphs (a)(1)(iii)(B) through (E) of this section provide certain alternative periods during which interest is not required to be charged on certain indebtedness. These exceptions apply only to indebtedness described in paragraph (a)(1)(ii)(A)(*2*) of this section (relating to indebtedness incurred in the ordinary course of business from sales, services, etc., between the period prior to the effective date of these regulations, the final sentence of section 482 must be applied using any reasonable method not inconsistent with the statute. The IRS considers a method that applies these regulations or their general principles to be a reasonable method.

(4) These regulations will not apply with respect to transfers made or licenses granted to foreign persons before November 17, 1985, or before August 17, 1986, for transfers or licenses to others. Nevertheless, they will apply with respect to transfers or licenses before such dates if, with respect to property transferred pursuant to an earlier and continuing transfer agreement, such property was not in existence or owned by the taxpayer on such date.

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of § 1.482–5 apply for taxable years beginning on or after August 26, 2003.

[T.D. 8552, 59 FR 34990, July 8, 1994, as amended by T.D. 9088, 68 FR 51177, Aug. 26, 2003]

§ 1.482–2 Determination of taxable income in specific situations.

(a) *Loans or advances*—(1) *Interest on bona fide indebtedness*—(i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district director may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

(ii) *Application of paragraph (a) of this section*—(A) *Interest on bona fide indebtedness.* Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including—

(*1*) Loans or advances of money or other consideration (whether or not evidenced by a written instrument); and

(*2*) Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

(B) *Alleged indebtedness.* This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness, even if the stated rate of interest thereon would be within the safe haven rates prescribed in paragraph (a)(2)(iii) of this section. For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Similarly, this paragraph (a) does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property. Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. See § 1.482–2(a)(3)(i).

(iii) *Period for which interest shall be charged*—(A) *General rule.* This paragraph (a)(1)(iii) is effective for indebtedness arising after June 30, 1988. See § 1.482–2(a)(3) (26 CFR Part 1 edition revised as of April 1, 1988) for indebtedness arising before July 1, 1988. Except as otherwise provided in paragraphs (a)(1)(iii)(B) through (E) of this section, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise). Paragraphs (a)(1)(iii)(B) through (E) of this section provide certain alternative periods during which interest is not required to be charged on certain indebtedness. These exceptions apply only to indebtedness described in paragraph (a)(1)(ii)(A)(*2*) of this section (relating to indebtedness incurred in the ordinary course of business from sales, services, etc., between members of the group) and not evidenced by a written instrument requiring the payment of interest. Such amounts are hereinafter referred to as intercompany trade receivables. The period for which interest is not required to be charged on intercompany trade receivables under this paragraph (a)(1)(iii) is called the interest-free period. In general, an intercompany trade receivable arises at the time economic performance occurs (within the meaning of section 461(h) and the regulations thereunder) with respect to the underlying transaction between controlled entities. For purposes of this paragraph (a)(1)(iii), the term United States includes any possession of the United States, and the term foreign country excludes any possession of the United States.

(B) *Exception for certain intercompany transactions in the ordinary course of business.* Interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises.

(C) *Exception for trade or business of debtor member located outside the United States.* In the case of an intercompany trade receivable arising from a transaction in the ordinary course of a trade or business which is actively conducted outside the United States by the debtor member, interest is not required to be charged until the first day of the fourth calendar month following the month in which such intercompany trade receivable arises.

(D) *Exception for regular trade practice of creditor member or others in creditor's industry.* If the creditor member or unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated parties a longer period without charging interest than that described in paragraph (a)(1)(iii)(B) or (C) of this section (whichever is applicable) with respect to transactions which are similar to transactions that give rise to intercompany trade receivables, such longer interest-free period shall be allowed with respect to a comparable amount of intercompany trade receivables.

(E) *Exception for property purchased for resale in a foreign country—(1) General rule.* If in the ordinary course of business one member of the group (related purchaser) purchases property from another member of the group (related seller) for resale to unrelated persons located in a particular foreign country, the related purchaser and the related seller may use as the interest-free period for the intercompany trade receivables arising during the related seller's taxable year from the purchase of such property within the same product group an interest-free period equal the sum of—

(*i*) The number of days in the related purchaser's average collection period (as determined under paragraph (a)(1)(iii)(E)(*2*) of this section) for sales of property within the same product group sold in the ordinary course of business to unrelated persons located in the same foreign country; plus

(*ii*) Ten (10) calendar days.

(*2*) *Interest-free period.* The interest-free period under this paragraph (a)(1)(iii)(E), however, shall in no event exceed 183 days. The related purchaser does not have to conduct business outside the United States in order to be eligible to use the interest-free period of this paragraph (a)(1)(iii)(E). The interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to intercompany trade receivables attributable to property which is manufactured, produced, or constructed (within the meaning of § 1.954–3(a)(4)) by the related purchaser. For purposes of this paragraph (a)(1)(iii)(E) a product group includes all products within the same three-digit Standard Industrial Classification (SIC) Code (as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President.)

(*3*) *Average collection period.* An average collection period for purposes of this paragraph (a)(1)(iii)(E) is determined as follows—

(*i*) *Step 1.* Determine total sales (less returns and allowances) by the related purchaser in the product group to unrelated persons located in the same foreign country during the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*ii*) *Step 2.* Determine the related purchaser's average month-end accounts receivable balance with respect to sales described in paragraph (a)(1)(iii)(E)(*2*)(*i*) of this section for the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(*iii*) *Step 3.* Compute a receivables turnover rate by dividing the total sales amount described in paragraph (a)(1)(iii)(E)(*2*)(*i*) of this section by the average receivables balance described in paragraph (a)(1)(iii)(E)(*2*)(*ii*) of this section.

(*iv*) *Step 4.* Divide the receivables turnover rate determined under paragraph (a)(1)(iii)(E)(*2*)(*iii*) of this section into 365, and round the result to the nearest whole number to determine the number of days in the average collection period.

(*v*) *Other considerations.* If the related purchaser makes sales in more than one foreign country, or sells property in more than one product group in any foreign country, separate computations of an average collection period, by product group within each country, are required. If the related purchaser resells fungible property in more than one foreign country and the intercompany trade receivables arising from the related party purchase of such fungible property cannot reasonably be identified with resales in particular foreign countries, then solely for the purpose of assigning an interest-free period to such intercompany trade receivables under this paragraph (a)(1)(iii)(E), an amount of each such intercompany trade receivable shall be treated as allocable to a particular foreign country in the same proportion that the related purchaser's sales of such fungible property in such foreign country during the period described in paragraph (a)(1)(iii)(E)(2)(i) of this section bears to the related purchaser's sales of all such fungible property in all such foreign countries during such period. An interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to any intercompany trade receivables arising in a taxable year of the related seller if the related purchaser made no sales described in paragraph (a)(1)(iii)(E)(2)(i) of this section from which the appropriate interest-free period may be determined.

(*4*) *Illustration.* The interest-free period provided under paragraph (a)(1)(iii)(E) of this section may be illustrated by the following example:

Example—(i) Facts. X and Y use the calendar year as the taxable year and are members of the same group of controlled entities within the meaning of section 482. For Y's 1988 calendar taxable year X and Y intend to use the interest-free period determined under this paragraph (a)(1)(iii)(E) for intercompany trade receivables attributable to X's purchases of certain products from Y for resale by X in the ordinary course of business to unrelated persons in country Z. For its 1987 calendar taxable year all of X's sales in country Z were of products within a single product group based upon a three-digit SIC code, were not manufactured, produced, or constructed (within the meaning of §1.954–3(a)(4)) by X, and were sold in the ordinary course of X's trade or business to unrelated persons located only in country Z. These sales and the month-end accounts receivable balances (for such sales and for such sales uncollected from prior months) are as follows:

Month	Sales	Accounts receivable
Jan. 1987	$500,000	$2,835,850
Feb.	600,000	2,840,300
Mar.	450,000	2,850,670
Apr.	550,000	2,825,700
May.	650,000	2,809,360
June	525,000	2,803,200
July	400,000	2,825,850
Aug.	425,000	2,796,240
Sept.	475,000	2,839,390
Oct.	525,000	2,650,550
Nov.	450,000	2,775,450
Dec. 1987	650,000	2,812,600
Totals	6,200,000	33,665,160

(ii) *Average collection period.* X's total sales within the same product group to unrelated persons within country Z for the period are $6,200,000. The average receivables balance for the period is $2,805,430 ($33,665,160/12). The average collection period in whole days is determined as follows:

$$\text{Receivables Turnover Rate} = \frac{\$6{,}200{,}000}{\$2{,}805{,}430} = 2.21$$

$$\begin{array}{c}\text{Average Collection}\\ \text{Period}\end{array} = \frac{365}{2.21} = \begin{array}{c}\text{165.16 days, rounded to the}\\ \text{nearest whole day} = 165\text{ days.}\end{array}$$

(iii) *Interest-free period*. Accordingly, for intercompany trade receivables incurred by X during Y's 1988 calendar taxable year attributable to the purchase of property from Y for resale to unrelated persons located in country Z and included in the product group, X may use an interest-free period of 175 days (165 days in the average collection period plus 10 days, but not in excess of a maximum of 183 days). All other intercompany trade receivables incurred by X are subject to the interest-free periods described in paragraphs (a)(1)(iii) (B), (C), or (D), whichever are applicable. If X makes sales in other foreign countries in addition to country Z or makes sales of property in more than one product group in any foreign country, separate computations of X's average collection period, by product group within each country, are required in order for X and Y to determine an interest-free period for such product groups in such foreign countries under this paragraph (a)(1)(iii)(E).

(iv) *Payment; book entries*—(A) Except as otherwise provided in this paragraph (a)(1)(iv), in determining the period of time for which an amount owed by one member of the group to another member is outstanding, payments or other credits to an account are considered to be applied against the earliest amount outstanding, that is, payments or credits are applied against amounts in a first-in, first-out (FIFO) order. Thus, tracing payments to individual intercompany trade receivables is generally not required in order to determine whether a particular intercompany trade receivable has been paid within the applicable interest-free period determined under paragraph (a)(1)(iii) of this section. The application of this paragraph (a)(1)(iv)(A) may be illustrated by the following example:

Example (i) *Facts*. X and Y are members of a group of controlled entities within the meaning of section 482. Assume that the balance of intercompany trade receivables owed by X to Y on June 1 is $100, and that all of the $100 balance represents amounts incurred by X to Y during the month of May. During the month of June X incurs an additional $200 of intercompany trade receivables to Y. Assume that on July 15, $60 is properly credited against X's intercompany account to Y, and that $240 is properly credited against the intercompany account on August 31. Assume that under paragraph (a)(1)(iii)(B) of this section interest must be charged on X's intercompany trade receivables to Y beginning with the first day of the third calendar month following the month the intercompany trade receivables arise, and that no alternative interest-free period applies. Thus, the interest-free period for intercompany trade receivables incurred during the month of May ends on July 31, and the interest-free period for intercompany trade receivables incurred during the month of June ends on August 31.

(ii) *Application of payments*. Using a FIFO payment order, the aggregate payments of $300 are applied first to the opening June balance, and then to the additional amounts incurred during the month of June. With respect to X's June opening balance of $100, no interest is required to be accrued on $60 of such balance paid by X on July 15, because such portion was paid within its interest-free period. Interest for 31 days, from August 1 to August 31 inclusive, is required to be accrued on the $40 portion of the opening balance not paid until August 31. No interest is required to be accrued on the $200 of intercompany trade receivables X incurred to Y during June because the $240 credited on August 31, after eliminating the $40 of indebtedness remaining from periods before June, also eliminated the $200 incurred by X during June prior to the end of the interest-free period for that amount. The amount of interest incurred by X to Y on the $40 amount during August creates bona fide indebtedness between controlled entities and is subject to the provisions of paragraph (a)(1)(iii)(A) of this section without regard to any of the exceptions contained in paragraphs (a)(1)(iii)(B) through (E).

(B) Notwithstanding the first-in, first-out payment application rule described in paragraph (a)(1)(iv)(A) of this section, the taxpayer may apply payments or credits against amounts owed in some other order on its books in accordance with an agreement or understanding of the related parties if the taxpayer can demonstrate that either it or others in its industry, as a regular trade practice, enter into such agreements or understandings in the case of similar balances with unrelated parties.

(2) *Arm's length interest rate*—(i) *In general.* For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

(ii) *Funds obtained at situs of borrower.* Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

(iii) *Safe haven interest rates for certain loans and advances made after May 8, 1986*—(A) *Applicability*—(*1*) *General rule.* Except as otherwise provided in paragraph (a)(2) of this section, paragraph (a)(2)(iii)(B) applies with respect to the rate of interest charged and to the amount of interest paid or accrued in any taxable year—

(*i*) Under a term loan or advance between members of a group of controlled entities where (except as provided in paragraph (a)(2)(iii)(A)(*2*)(*ii*) of this section) the loan or advance is entered into after May 8, 1986; and

(*ii*) After May 8, 1986 under a demand loan or advance between such controlled entities.

(*2*) *Grandfather rule for existing loans.* The safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the safe haven rates prescribed in § 1.482–2(a)(2)(iii) (26 CFR part 1 edition revised as of April 1, 1985), shall apply to—

(*i*) Term loans or advances made before May 9, 1986; and

(*ii*) Term loans or advances made before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(B) *Safe haven interest rate based on applicable Federal rate.* Except as otherwise provided in this paragraph (a)(2), in the case of a loan or advance between members of a group of controlled entities, an arm's length rate of interest referred to in paragraph (a)(2)(i) of this section shall be for purposes of chapter 1 of the Internal Revenue Code—

(*1*) The rate of interest actually charged if that rate is—

(*i*) Not less than 100 percent of the applicable Federal rate (lower limit); and

(*ii*) Not greater than 130 percent of the applicable Federal rate (upper limit); or

(*2*) If either no interest is charged or if the rate of interest charged is less than the lower limit, then an arm's length rate of interest shall be equal to the lower limit, compounded semiannually; or

(*3*) If the rate of interest charged is greater than the upper limit, then an arm's length rate of interest shall be equal to the upper limit, compounded semiannually, unless the taxpayer establishes a more appropriate compound rate of interest under paragraph (a)(2)(i) of this section. However, if the compound rate of interest actually charged is greater than the upper limit and less than the rate determined under paragraph (a)(2)(i) of this section, or if the compound rate actually charged is less than the lower limit and greater than the rate determined under paragraph (a)(2)(i) of this section, then the compound rate actually charged shall be deemed to be an arm's length rate under paragraph (a)(2)(i). In the case of any sale-leaseback described in section 1274(e), the lower limit shall be 110 percent of the applicable Federal rate, compounded semiannually.

(C) *Applicable Federal rate.* For purposes of paragraph (a)(2)(iii)(B) of this section, the term applicable Federal rate means, in the case of a loan or advance to which this section applies and having a term of—

(*1*) Not over 3 years, the Federal short-term rate;

(*2*) Over 3 years but not over 9 years, the Federal mid-term rate; or

(*3*) Over 9 years, the Federal long-term rate, as determined under section 1274(d) in effect on the date such loan or advance is made. In the case of any sale or exchange between controlled entities, the lower limit shall be the lowest of the applicable Federal rates in effect for any month in the 3-calendar- month period ending with the first calendar month in which there is a binding written contract in effect for such sale or exchange (lowest 3-month rate, as defined in section 1274(d)(2)). In the case of a demand loan or advance to which this section applies, the applicable Federal rate means the Federal short-term rate determined under section 1274(d) (determined without regard to the lowest 3-month short term rate determined under section 1274(d)(2)) in effect for each day on which any amount of such loan or advance (including unpaid accrued interest determined under paragraph (a)(2) of this section) is outstanding.

(D) *Lender in business of making loans.* If the lender in a loan or advance transaction to which paragraph (a)(2) of this section applies is regularly engaged in the trade or business of making loans or advances to unrelated parties, the safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the arm's length interest rate to be used shall be determined under the standards described in paragraph (a)(2)(i) of this section, including reference to the interest rates charged in such trade or business by the lender on loans or advances of a similar type made to unrelated parties at and about the time the loan or advance to which paragraph (a)(2) of this section applies was made.

(E) *Foreign currency loans.* The safe haven interest rates prescribed in paragraph (a)(2)(iii)(B) of this section do not apply to any loan or advance the principal or interest of which is expressed in a currency other than U.S. dollars.

(3) *Coordination with interest adjustments required under certain other Code sections.* If the stated rate of interest on the stated principal amount of a loan or advance between controlled entities is subject to adjustment under section 482 and is also subject to adjustment under any other section of the Internal Revenue Code (for example, section 467, 483, 1274 or 7872), section 482 and paragraph (a) of this section may be applied to such loan or advance in addition to such other Internal Revenue Code section. After the enactment of the Tax Reform Act of 1964, Pub. L. 98–369, and the enactment of Pub. L. 99–121, such other Internal Revenue Code sections include sections 467, 483, 1274 and 7872. The order in which the different provisions shall be applied is as follows—

(i) First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply. Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness (within the meaning of paragraph (a)(1) of this section), if any, shall be subject to adjustment under section 482, paragraph (a) of this section, and any other Internal Revenue Code section.

(ii) Second, the other Internal Revenue Code section shall be applied to the loan or advance to determine whether any amount other than stated interest is to be treated as interest, and if so, to determine such amount according to the provisions of such other Internal Revenue Code section.

(iii) Third, whether or not the other Internal Revenue Code section applies to adjust the amounts treated as interest under such loan or advance, section 482 and paragraph (a) of this section may then be applied by the district director to determine whether the rate of interest charged on the loan or advance, as adjusted by any other Code section, is greater or less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(iv) Fourth, section 482 and paragraphs (b) through (d) of this section and §§ 1.482–3 through 1.482–7, if applicable, may be applied by the district director to make any appropriate allocations, other than an interest rate adjustment, to reflect an arm's length transaction based upon the principal amount of the loan or advance and the interest rate as adjusted under paragraph (a)(3) (i), (ii) or (iii) of this section. For example, assume that two commonly controlled taxpayers enter into a deferred payment sale of tangible property and no interest is provided, and assume also that section 483 is applied to treat a portion of the stated sales price as interest, thereby reducing the stated sales price. If after this recharacterization of a portion of the stated sales price as interest, the recomputed sales price does not reflect an arm's length sales price under the principles of § 1.482–3, the district director may make other appropriate allocations (other than an interest rate adjustment) to reflect an arm's length sales price.

(4) *Examples.* The principles of paragraph (a)(3) of this section may be illustrated by the following examples:

Example 1. An individual, A, transfers $20,000 to a corporation controlled by A in exchange for the corporation's note which bears adequate stated interest. The district director recharacterizes the transaction as a contribution to the capital of the corporation in exchange for preferred stock. Under paragraph (a)(3)(i) of this section, section 1.482–2(a) does not apply to the transaction because there is no bona fide indebtedness.

Example 2. B, an individual, is an employee of Z corporation, and is also the controlling shareholder of Z. Z makes a term loan of $15,000 to B at a rate of interest that is less than the applicable Federal rate. In this instance the other operative Code section is section 7872. Under section 7872(b), the difference between the amount loaned and the present value of all payments due under the loan using a discount rate equal to 100 percent of the applicable Federal rate is treated as an amount of cash transferred from the corporation to B and the loan is treated as having original issue discount equal to such amount. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may also be applied by the district director to determine if the rate of interest charged on this $15,000 loan (100 percent of the AFR, compounded semiannually, as adjusted by section 7872) is an arm's length rate of interest. Because the rate of interest on the loan, as adjusted by section 7872, is within the safe haven range of 100–130 percent of the AFR, compounded semiannually, no further interest rate adjustments under section 482 and paragraph (a) of this section will be made to this loan.

Example 3. The facts are the same as in Example 2 except that the amount lent by Z to B is $9,000, and that amount is the aggregate outstanding amount of loans between Z and B. Under the $10,000 de minimis exception of section 7872(c)(3), no adjustment for interest will be made to this $9,000 loan under section 7872. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $9,000 loan to determine whether the rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

Example 4. X and Y are commonly controlled taxpayers. At a time when the applicable Federal rate is 12 percent, compounded semiannually, X sells property to Y in exchange for a note with a stated rate of interest of 18 percent, compounded semiannually. Assume that the other applicable Code section to the transaction is section 483. Section 483 does not apply to this transaction because, under section 483(d), there is no total unstated interest under the contract using the test rate of interest equal to 100 percent of the applicable Federal rate. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may be applied by the district director to determine whether the rate of interest under the note is excessive, that is, to determine whether the 18 percent stated interest rate under the note exceeds an arm's length rate of interest.

Example 5. Assume that A and B are commonly controlled taxpayers and that the applicable Federal rate is 10 percent, compounded semiannually. On June 30, 1986, A sells property to B and receives in exchange B's purchase-money note in the amount of $2,000,000. The stated interest rate on the note is 9%, compounded semiannually, and the stated redemption price at maturity on the note is $2,000,000. Assume that the other applicable Code section to this transaction is section 1274. As provided in section 1274A(a) and (b), the discount rate for purposes of section 1274 will be nine percent, compounded semiannually, because the stated principal amount of B's note does not exceed $2,800,000. Section 1274 does not apply to this transaction because there is adequate stated interest on the debt instrument using a discount rate equal to 9%, compounded semiannually, and the stated redemption price at maturity does not exceed the stated principal amount. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $2,000,000 note to determine whether the 9% rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(b) *Performance of services for another*—(1) *General rule.* Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in paragraph (b)(3) of this section, the district director may make appropriate allocations to reflect an arm's length charge for such services.

(2) *Benefit test*—(i) Allocations may be made to reflect arm's length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities, as well as with respect to services performed by one member of the group exclusively for the benefit of another member of the group. Any allocations made shall be consistent with the relative benefits intended from the services, based upon the facts known at the time the services were rendered, and shall be made even if the potential benefits anticipated are not realized. No allocations shall be made if the probable benefits to the other members were so indirect or remote that unrelated parties would not have charged for such services. In general, allocations may be made if the service, at the time it was performed, related to the carrying on of an activity by another member or was intended to benefit another member, either in the member's overall operations or in its day-to-day activities. The principles of this paragraph (b)(2)(i) may be illustrated by the following examples in each of which it is assumed that X and Y are corporate members of the same group of controlled entities:

Example 1. X's International Division engages in a wide range of sales promotion activities. Although most of these activities are undertaken exclusively for the benefit of X's international operations, some are intended to jointly benefit both X and Y and others are undertaken exclusively for the benefit of Y. The district director may make an allocation to reflect an arm's length charge with respect to the activities undertaken for the joint benefit of X and Y consistent with the relative benefits intended as well as with respect to the services performed exclusively for the benefit of Y.

Example 2. X operates an international airline, and Y owns and operates hotels in several cities which are serviced by X. X, in conjunction with its advertising of the airline, often pictures Y's hotels and mentions Y's name. Although such advertising was primarily intended to benefit X's airline operations, it was reasonable to anticipate that there would be substantial benefits to Y resulting from patronage by travelers who responded to X's advertising. Since an unrelated hotel operator would have been charged for such advertising, the district director may make an appropriate allocation to reflect an arm's length charge consistent with the relative benefits intended.

Example 3. Assume the same facts as in Example 2 except that X's advertising neither mentions nor pictures Y's hotels. Although it is reasonable to anticipate that increased air travel attributable to X's advertising will result in some benefit to Y due to increased patronage by air travelers, the district director will not make an allocation with respect to such advertising since the probable benefit to Y was so indirect and remote that an unrelated hotel operator would not have been charged for such advertising.

(ii) Allocations will generally not be made if the service is merely a duplication of a service which the related party has independently performed or is performing for itself. In this connection, the ability to independently perform the service (in terms of qualification and availability of personnel) shall be taken into account. The principles of this paragraph (b)(2)(ii) may be illustrated by the following examples, in each of which it is assumed that X and Y are corporate members of the same group of controlled entities:

Example 1. At the request of Y, the financial staff of X makes an analysis to determine the amount and source of the borrowing needs of Y. Y does not have personnel qualified to make the analysis, and it does not undertake the same analysis. The district director may make an appropriate allocation to reflect an arm's length charge for such analysis.

Example 2. Y, which has a qualified financial staff, makes an analysis to determine the amount and source of its borrowing needs. Its report, recommending a loan from a bank, is submitted to X. X's financial staff reviews the analysis to determine whether X should advise Y to reconsider its plan. No allocation should be made with respect to X's review.

(3) *Arm's length charge.* For the purpose of this paragraph an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts. However, except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services (as described in paragraph (b)(7) of this section) the arm's length charge shall be deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services unless the taxpayer establishes a more appropriate charge under the standards set forth in the first sentence of this subparagraph. Where costs or deductions are a factor in applying the provisions of this paragraph adequate books and records must be maintained by taxpayers to permit verification of such costs or deductions by the Internal Revenue Service.

(4) *Costs or deductions to be taken into account*—(i) Where the amount of an arm's length charge for services is determined with reference to the costs or deductions incurred with respect to such services, it is necessary to take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the service performed.

(ii) Direct costs or deductions are those identified specifically with a particular service. These include, but are not limited to, costs or deductions for compensation, bonuses, and travel expenses attributable to employees directly engaged in performing such services, for material and supplies directly consumed in rendering such services, and for other costs such as the cost of overseas cables in connection with such services.

(iii) Indirect costs or deductions are those which are not specifically identified with a particular activity or service but which relate to the direct costs referred to in paragraph (b)(4)(ii) of this section. Indirect costs or deductions generally include costs or deductions with respect to utilities, occupancy, supervisory and clerical compensation, and other overhead burden of the department incurring the direct costs or deductions referred to in paragraph (b)(4)(ii) of this section. Indirect costs or deductions also generally include an appropriate share of the costs or deductions relating to supporting departments and other applicable general and administrative expenses to the extent reasonably allocable to a particular service or activity. Thus, for example, if a domestic corporation's advertising department performs services for the direct benefit of a foreign subsidiary, in addition to direct costs of such department, such as salaries of employees and fees paid to advertising agencies or consultants, which are attributable to such foreign advertising, indirect costs must be taken into account on some reasonable basis in determining the amount of costs or deductions with respect to which the arm's length charge to the foreign subsidiary is to be determined. These generally include depreciation, rent, property taxes, other costs of occupancy, and other overhead costs of the advertising department itself, and allocations of costs from other departments which service the advertising department, such as the personnel, accounting, payroll, and maintenance departments, and other applicable general and administrative expenses including compensation of top management.

(5) *Costs and deductions not to be taken into account.* Costs or deductions of the member rendering the services which are not to be taken into account in determining the amount of an arm's length charge for services include—

(i) Interest expense on indebtedness not incurred specifically for the benefit of another member of the group;

(ii) Expenses associated with the issuance of stock and maintenance of shareholder relations; and

(iii) Expenses of compliance with regulations or policies imposed upon the member rendering the services by its government which are not directly related to the service in question.

(6) *Methods*—(i) Where an arm's length charge for services rendered is

determined with reference to costs or deductions, and a member has allocated and apportioned costs or deductions to reflect arm's length charges by employing in a consistent manner a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice, such method will not be disturbed. If the member has not employed a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice, the method of allocating and apportioning costs or deductions for the purpose of determining the amount of arm's length charges shall be based on the particular circumstances involved.

(ii) The methods of allocation and apportionment referred to in this paragraph (b)(6) are applicable both in allocating and apportioning indirect costs to a particular activity or service (see paragraph (b)(4)(iii) of this section) and in allocating and apportioning the total costs (direct and indirect) of a particular activity or service where such activity or service is undertaken for the joint benefit of two or more members of a group (see paragraph (b)(2)(i) of this section). While the use of one or more bases may be appropriate under the circumstances, in establishing the method of allocation and apportionment, appropriate consideration should be given to all bases and factors, including, for example, total expenses, asset size, sales, manufacturing expenses, payroll, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by means of application of reasonable departmental overhead rates Allocations and apportionments of costs or deductions must be made on the basis of the full cost as opposed to the incremental cost. Thus, if an electronic data processing machine, which is rented by the taxpayer, is used for the joint benefit of itself and other members of a controlled group, the determination of the arm's length charge to each member must be made with reference to the full rent and cost of operating the machine by each member, even if the additional use of the machine for the benefit of the other members did not increase the cost to the taxpayer.

(iii) Practices actually employed to apportion costs or expenses in connection with the preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest shall be considered by the district director. Similarly, in determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members of a controlled group in apportioning costs between themselves shall also be considered if the relationships with the foreign members of the group are comparable to the relationships between the domestic members of the group. For example, if, for purposes of reporting to public stockholders or to a governmental agency, a corporation apportions the costs attributable to its executive officers among the domestic members of a controlled group on a reasonable and consistent basis, and such officers exercise comparable control over foreign members of such group, such domestic apportionment practice will be taken into consideration in determining the amount of allocations to be made to the foreign members.

(7) *Certain services.* An arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (referred to in this paragraph (b) as the renderer) or the member receiving the benefit of the services (referred to in this paragraph (b) as the recipient). Paragraphs (b)(7)(i) through (b)(7)(iv) of this section describe those situations in which services shall be considered an integral part of the business activity of a member of a group of controlled entities.

(i) Services are an integral part of the business activity of a member of a controlled group where either the renderer or the recipient is engaged in the trade or business of rendering similar services to one or more unrelated parties.

(ii) (A) Services are an integral part of the business activity of a member of a controlled group where the renderer renders services to one or more related parties as one of its principal activities. Except in the case of services which constitute a manufacturing, production, extraction, or construction activity, it will be presumed that the renderer does not render services to related parties as one of its principal activities if the cost of services of the renderer attributable to the rendition of services for the taxable year to related parties does not exceed 25 percent of the total costs or deductions of the renderer for the taxable year. Where the cost of services rendered to related parties is in excess of 25 percent of the total costs or deductions of the renderer for the taxable year or where the 25-percent test does not apply, the determination of whether the rendition of such services is one of the principal activities of the renderer will be based on the facts and circumstances of each particular case. Such facts and circumstances may include the time devoted to the rendition of the services, the relative cost of the services, the regularity with which the services are rendered, the amount of capital investment, the risk of loss involved, and whether the services are in the nature of supporting services or independent of the other activities of the renderer.

(B) For purposes of the 25-percent test provided in this paragraph (b)(7)(ii), the cost of services rendered to related parties shall include all costs or deductions directly or indirectly related to the rendition of such services including the cost of services which constitute a manufacturing, production, extraction, or construction activity; and the total costs or deductions of the renderer for the taxable year shall exclude amounts properly reflected in the cost of goods sold of the renderer. Where any of the costs or deductions of the renderer do not reflect arm's length consideration and no adjustment is made under any provision of the Internal Revenue Code to reflect arm's length consideration, the 25-percent test will not apply if, had an arm's length charge been made, the costs or deductions attributable to the renderer's rendition of services to related entities would exceed 25 percent of the total costs or deductions of the renderer for the taxable year.

(C) For purposes of the 25-percent test in this paragraph (b)(7)(ii), a consolidated group (as defined in this paragraph (b)(7)(ii)(C)) may, at the option of the taxpayer, be considered as the renderer where one or more members of the consolidated group render services for the benefit of or on behalf of a related party which is not a member of the consolidated group. In such case, the cost of services rendered by members of the consolidated group to any related parties not members of the consolidated group, as well as the total costs or deductions of the members of the consolidated group, shall be considered in the aggregate to determine if such services constitute a principal activity of the renderer. Where a consolidated group is considered the renderer in accordance with this paragraph (b)(7)(ii)(C), the costs or deductions referred to in this paragraph (b)(7)(ii) shall not include costs or deductions paid or accrued to any member of the consolidated group. In addition to the preceding provisions of this paragraph (b)(7)(ii)(C), if part or all of the services rendered by a member of a consolidated group to any related party not a member of the consolidated group are similar to services rendered by any other member of the consolidated group to unrelated parties as part of a trade or business, the 25-percent test in this paragraph (b)(7)(ii) shall be applied with respect to such similar services without regard to this paragraph (b)(7)(ii)(C). For purposes of this paragraph (b)(7)(ii)(C), the term consolidated group means all members of a group of controlled entities created or organized within a single country and subjected to an income tax by such country on the basis of their combined income.

(iii) Services are an integral part of the business activity of a member of a controlled group where the renderer is peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient. The renderer is peculiarly capable of rendering the services where the renderer, in connection with the rendition of such services, makes use of a particularly advantageous situation or circumstance such as by utilization of special skills and reputation, utilization of an influential relationship with customers, or utilization of its intangible property (as defined in § 1.482–4(b)). However, the renderer will not be considered peculiarly capable of rendering services unless the value of the services is substantially in excess of the costs or deductions of the renderer attributable to such services.

(iv) Services are an integral part of the business activity of a member of a controlled group where the recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year. For purposes of this paragraph (b)(7)(iv), services rendered by one or more related parties shall be considered substantial in amount if the total costs or deductions of the related party or parties rendering services to the recipient during its taxable year which are directly or indirectly related to such services exceed an amount equal to 25 percent of the total costs or deductions of the recipient during its taxable year. For purposes of the preceding sentence, the total costs or deductions of the recipient shall include the renderers' costs or deductions directly or indirectly related to the rendition of such services and shall exclude any amounts paid or accrued to the renderers by the recipient for such services and shall also exclude any amounts paid or accrued for materials the cost of which is properly reflected in the cost of goods sold of the recipient. At the option of the taxpayer, where the taxpayer establishes that the amount of the total costs or deductions of a recipient for the recipient's taxable year are abnormally low due to the commencement or cessation of an operation by the recipient, or other unusual circumstances of a nonrecurring nature, the costs or deductions referred to in the preceding two sentences shall be the total of such amount for the 3-year period immediately preceding the close of the taxable year of the recipient (or for the first 3 years of operation of the recipient if the recipient had been in operation for less than 3 years as of the close of the taxable year in which the services in issue were rendered).

(v) The principles of paragraphs (b)(7)(i) through (iv) of this section may be illustrated by the following examples:

Example 1. Y is engaged in the business of selling merchandise and X, an entity related to Y, is a printing company regularly engaged in printing and mailing advertising literature for unrelated parties. X also prints circulars advertising Y's products, mails the circulars to potential customers of Y, and in addition, performs the art work involved in the preparation of the circulars. Since the printing, mailing, and art work services rendered by X to Y are similar to the printing and mailing services rendered by X as X's trade or business, the services rendered to Y are an integral part of the business activity of X as described in paragraph (b)(7)(i) of this section.

Example 2. V, W, X, and Y are members of the same group of controlled entities. Each member of the group files a separate income tax return. X renders wrecking services to V, W, and Y, and, in addition, sells building materials to unrelated parties. The total costs or deductions incurred by X for the taxable year (exclusive of amounts properly reflected in the cost of goods sold of X) are $4 million. The total costs or deductions of X for the taxable year which are directly or indirectly related to the services rendered to V, W, and Y are $650,000. Since $650,000 is less than 25 percent of the total costs or deductions of X (exclusive of amounts properly reflected in the cost of goods sold of X) for the taxable year ($4,000,000 * 25% = $1,000,000), the services rendered by X to V, W, and Y will not be considered one of X's principal activities within the meaning of paragraph (b)(7)(ii) of this section.

Example 3. Assume the same facts as in *Example 2,* except that the total costs or deductions of X for the taxable year which are directly or indirectly related to the services rendered to V, W, and Y are $1,800,000. Assume in addition, that there is a high risk of loss involved in the rendition of the wrecking services by X, that X has a large investment in the wrecking equipment, and that a substantial amount of X's time is devoted to the rendition of wrecking services to V, W, and Y. Since $1,800,000 is greater than 25 percent of the total costs or deductions of X for the taxable year (exclusive of amounts properly reflected in the cost of goods sold of X), i.e., $1 million, the services rendered by X to V, W, and Y will not be automatically excluded from classification as one of the principal activities of X as in *Example 2,* and consideration must be given to the facts and circumstances of the particular case. Based on the facts and circumstances in this case, X would be considered to render wrecking services to related parties as one of its principal activities. Thus, the wrecking services are an integral part of the business activity of X as described in paragraph (b)(7)(ii) of this section.

Example 4. Z is a domestic corporation and has several foreign subsidiaries. Z and X, a domestic subsidiary of Z, have exercised the privilege granted under section 1501 to file a consolidated return and, therefore, constitute a *consolidated group* within the meaning of paragraph (b)(7)(ii)(C) of this section. Pursuant to paragraph (b)(7)(ii)(C) of this section, the taxpayer treats X and Z as the renderer. The sole function of X is to provide accounting, billing, communication, and travel services to the foreign subsidiaries of Z. Z also provides some other services for the benefit of its foreign subsidiaries. The total costs or deductions of X and Z related to the services rendered for the benefit of the foreign subsidiaries is $750,000. Of that amount, $710,000 represents the costs of X, which are X's total operating costs. The total costs or deductions of X and Z for the taxable year with respect to their operations (exclusive of amounts properly reflected in the cost of goods sold of X and Z) is $6,500,000. Since the total costs or deductions related to the services rendered to the foreign subsidiaries ($750,000) is less than 25 percent of the total costs or deductions of X and Z (exclusive of amounts properly reflected in the costs of goods sold of X or Z) in the aggregate ($6,500,000 * 25% = $1,625,000), the services rendered by X and Z to the foreign subsidiaries will not be considered one of the principal activities of X and Z within the meaning of paragraph (b)(7)(ii) of this section.

Example 5. Assume the same facts as in *Example 4,* except that all the communication services rendered for the benefit of the foreign subsidiaries are rendered by X and that Z renders communication services to unrelated parties as part of its trade or business. X is regularly engaged in rendering communication services to foreign subsidiaries and devotes a substantial amount of its time to this activity. The costs or deductions of X related to the rendition of the communication services to the foreign subsidiaries are $355,000. By application of the paragraph (b)(7)(ii)(C) of this section, the services provided by X and Z to related entities other than the communication services will not be considered one of the principal activities of X and Z. However, since Z renders communication services to unrelated parties as a part of its trade or business, the communication services rendered by X to the foreign subsidiaries will be subject to the provisions of paragraph (b)(7)(ii) of this section without regard to paragraph (b)(7)(ii)(C) of this section. Since the costs or deductions of X related to the rendition of the communication services ($355,000) are in excess of 25 percent of the total costs or deductions of X (exclusive of amounts properly reflected in the cost of goods sold of X) for the taxable year ($710,000 * 25% = $177,500), the determination of whether X renders the communication services as one of its principal activities will depend on the particular facts and circumstances. The given facts and circumstances indicate that X renders the communication services as one of its principal activities.

Example 6. X and Y are members of the same group of controlled entities. Y produces and sells product D. As a part of the production process, Y sends materials to X who converts the materials into component parts. This conversion activity constitutes only a portion of X's operations. X then ships the component parts back to Y who assembles them (along with other components) into the finished product for sale to unrelated parties. Since the services rendered by X to Y constitute a manufacturing activity, the 25-percent test in paragraph (b)(7)(ii) of this section does not apply.

Example 7. X and Y are members of the same group of controlled entities. X manufactures product D for distribution and sale in the United States, Canada, and Mexico. Y manufactures product D for distribution and sale in South and Central America. Due to a breakdown of machinery, Y is forced to cease its manufacturing operations for a 1-month period. In order to meet demand for product D during the shutdown period, Y sends partially finished goods to X. X, for that period, completes the manufacture of product D for Y and ships the finished product back to Y. The costs or deductions of X related to the manufacturing services rendered to Y are $750,000. The total costs or deductions of X are $24,000,000. Since the services in issue constitute a manufacturing activity, the 25-percent test in paragraph (b)(7)(ii) of this section does not apply. However, under these facts and circumstances, i.e., the insubstantiality of the services rendered to Y in relation to X's total operations, the lack of regularity with which the services are rendered, and the short duration for which the services are rendered, X's rendition of manufacturing services to Y is not considered one of X's principal activities within the meaning of paragraph (b)(7)(ii) of this section.

Example 8. Assume the same facts as in *Example 7,* except that, instead of temporarily ceasing operations, Y requests assistance from X in correcting the defects in the manufacturing equipment. In response, X sends a team of engineers to discover and correct the defects without the necessity of a shutdown. Although the services performed by the engineers were related to a manufacturing activity, the services are essentially supporting in nature and, therefore, do not constitute a manufacturing, production, extraction, or construction activity. Thus, the 25-percent test in paragraph (b)(7)(ii) of this section applies.

Example 9. X is a domestic manufacturing corporation. Y, a foreign subsidiary of X, has decided to construct a plant in Country A. In connection with the construction of Y's plant, X draws up the architectural plans for the plant, arranges the financing of the construction, negotiates with various Government authorities in Country A, invites bids from unrelated parties for several phases of construction, and negotiates, on Y's behalf, the contracts with unrelated parties who are retained to carry out certain phases of the construction. Although the unrelated parties retained by X for Y perform the physical construction, the aggregate services performed by X for Y are such that they, in themselves, constitute a construction activity. Thus, the 25-percent test in paragraph (b)(7)(ii) of this section does not apply with respect to such services.

Example 10. X and Y are members of the same group of controlled entities. X is a finance company engaged in financing automobile loans. In connection with such loans it requires the borrower to have life insurance in the amount of the loan. Although X's borrowers are not required to take out life insurance from any particular insurance company, at the same time that the loan agreement is being finalized, X's employees suggest that the borrower take out life insurance from Y, which is an agency for life insurance companies. Since there would be a delay in the processing of the loan if some other company were selected by the borrower, almost all of X's borrowers take out life insurance through Y. Because of this utilization of its influential relationship with its borrowers, X is peculiarly capable of rendering selling services to Y and, since a substantial amount of Y's business is derived from X's borrowers, such selling services are a principal element in the operation of Y's insurance business. In addition, the value of the services is substantially in excess of the costs incurred by X. Thus, the selling services rendered by X to Y are an integral part of the business activity of a member of the controlled group as described in paragraph (b)(7)(iii) of this section.

Example 11. X and Y are members of the same group of controlled entities. Y is a manufacturer of product E. In past years product E has not always operated properly because of imperfections present in the finished product. X owns an exclusive patented process by which such imperfections can be detected and removed prior to sale of the product, thereby greatly increasing the marketability of the product. In connection with its manufacturing operations Y sends its products to X for inspection which involves utilization of the patented process. The inspection of Y's products by X is not one of the principal activities of X. However, X is peculiarly capable of rendering the inspection services to Y because of its utilization of the patented process. Since this inspection greatly increases the marketability of product E it is extremely valuable. Such value is substantially in excess of the cost incurred by X in rendition of such services. Because of the impact of the inspection on sales, such services are a principal element in the operations of Y. Thus, the inspection services rendered by X to Y are an integral part of the business activity of a member of the controlled group as described in paragraph (b)(7)(iii) of this section.

Example 12. Assume the same facts as in *Example 11* except that Y owns the patented process for detecting the imperfections. Y, however, does not have the facilities to implement the inspection process. Therefore, Y sends its products to X for inspection which involves utilization of the patented process owned by Y. Since Y owns the patent, X is not peculiarly capable of rendering the inspection services to Y within the meaning of paragraph (b)(7)(iii) of this section.

Example 13. Assume the same facts as in *Example 12* except that X and Y both own interests in the patented process as a result of having developed the process pursuant to a bona fide cost sharing plan (within the meaning of §1.482–7T). Since Y owns the requisite interest in the patent, X is not peculiarly capable of rendering the inspection services to Y within the meaning of paragraph (b)(7)(iii) of this section.

Example 14. X and Y are members of the same group of controlled entities. X is a large manufacturing concern. X's accounting department has, for many years, maintained the financial records of Y, a distributor of X's products. Although X is able to render these accounting services more efficiently than others due to its thorough familiarity with the operations of Y, X is not peculiarly capable of rendering the accounting services to Y because such familiarity does not, in and of itself, constitute a particularly advantageous situation or circumstance within the meaning of paragraph (b)(7)(iii) of this section. Furthermore, under these circumstances, the accounting services are supporting in nature and, therefore, do not constitute a principal element in the operations of Y. Thus, the accounting services rendered by X to Y are not an integral part of the business activity of either X or Y within the meaning of paragraph (b)(7)(iii) of this section.

Example 15. (i) Corporations X, Y, and Z are members of the same group of controlled entities. X is a manufacturer, and Y and Z are distributors of X's products. X provides a variety of services to Y including billing, shipping, accounting, and other general and administrative services. During Y's taxable year, on several occasions, Z renders selling and other promotional services to Y. None of the services rendered to Y constitute one of the principal activities of any of the renderers within the meaning of paragraph (b)(7)(ii) of this section. Y's total costs and deductions for Y's taxable year (exclusive of amounts paid to X and Z for services rendered and amounts paid for goods purchased for resale) are $1,600,000. The total direct and indirect costs of X and Z for services rendered to Y during Y's taxable year are as follows:

Services provided by X:	
Billing	$50,000
Shipping	250,000
Accounting	150,000
Other	200,000
Services provided by Z:	
Selling	500,000
Total Costs	1,150,000

(ii) Since the total costs or deductions of X and Z related to the rendition of services to Y exceed the amount equal to 25 percent of the total costs or deductions of Y (exclusive of amounts paid to X and Z for the services rendered and amounts paid for goods purchased for resale) plus the total costs or deductions of X and Z related to the rendition of services to Y ($1,150,000 ÷ [$1,600,000 + $1,150,000] = 41.8%), the services rendered by X and Z to Y are substantial within the meaning of paragraph (b)(7)(iv) of this section. Thus, the services rendered by X and Z to Y are an integral part of the business activity of Y as described in paragraph (b)(7)(iv) of this section.

Example 16. Assume the same facts as in *Example 15*, except that the taxpayer establishes that, due to a major change in the operations of Y, Y's total costs or deductions for Y's taxable year were abnormally low. Y has always used the calendar year as its taxable year. Y's total costs and deductions for the 2 years immediately preceding the taxable year in issue (exclusive of amounts paid to X and Z for services rendered and amounts paid for goods purchased for resale) were $6 million and $6,200,000 respectively. The total direct and indirect costs of X and Z for services rendered to Y were $1,150,000 for each of the 3 years. Applying the same formula to the costs or deductions for the 3 years immediately preceding the close of the taxable year in issue, the costs or deductions of X and Z related to the rendition of services to Y (3 * $1,150,000=$3,450,000) amount to 20 percent of the sum of the total costs or deductions of Y (exclusive of amounts paid to X and Z for the services rendered and amounts paid for goods purchased for resale) plus the total costs or deductions of X and Z related to the rendition of services to Y ($3,450,000 $1,600,000 + $6,000,000 + $6,200,000 + $3,450,000=20%). If the taxpayer chooses to use the 3-year period, the services rendered by X and Z to Y are not substantial within the meaning of paragraph (b)(7)(iv) of this section. Thus, the services will not be an integral part of the business activity of a member of the controlled group as described in paragraph (b)(7)(iv) of this section.

(8) *Services rendered in connection with the transfer of property.* Where tangible or intangible property is transferred, sold, assigned, loaned, leased, or otherwise made available in any manner by one member of a group to another member of the group and services are rendered by the transferor to the transferee in connection with the transfer, the amount of any allocation that may be appropriate with respect to such transfer shall be determined in accordance with the rules of paragraph (c) of this section, or §§ 1.482–3 or 1.482–4, whichever is appropriate and a separate allocation with respect to such services under this paragraph shall not be made. Services are rendered in connection with the transfer of property where such services are merely ancillary and subsidiary to the transfer of the property or to the commencement of effective use of the property by the transferee. Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact. Ancillary and subsidiary services could be performed, for example, in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective starting-up of the property transferred, or by performing under a guarantee relating to such effective starting-up. Thus, where an employee of one member of a group, acting under the instructions of his employer, reveals a valuable secret process owned by his employer to a related entity, and at the same time supervises the integration of such process into the manufacturing operation of the related entity, such services could be considered to be rendered in connection with the transfer, and, if so considered, shall not be the basis for a separate allocation. However, if the employee continues to render services to the related entity by supervising the manufacturing operation after the secret process has been effectively integrated into such operation, a separate allocation with respect to such additional services may

be made in accordance with the rules of this paragraph.

(c) *Use of tangible property*—(1) *General rule.* Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in paragraph (c)(2)(i) of this section) the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) *Arm's length charge*—(i) *In general.* For purposes of paragraph (c) of this section, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

(ii) *Safe haven rental charge.* See § 1.482–2(c)(2)(ii) (26 CFR Part 1 revised as of April 1, 1985), for the determination of safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(iii) *Subleases*—(A) Except as provided in paragraph (c)(2)(iii)(B) of this section, where possession, use, or occupancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period. Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(B) The provisions of paragraph (c)(2)(iii)(A) of this section shall not apply if either—

(*1*) The taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (c)(2)(i) of this section; or

(*2*) During the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the same general type as the property in question to unrelated persons.

(d) *Transfer of property.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving the transfer of property, see §§ 1.482–3 through 1.482–6.

[T.D. 8552, 59 FR 35002, July 8, 1994; 60 FR 16381, 16382, Mar. 30, 1995]

§ 1.482–3 Methods to determine taxable income in connection with a transfer of tangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the six methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of § 1.482–1, including the best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e). The methods are—

(1) The comparable uncontrolled price method, described in paragraph (b) of this section;

(2) The resale price method, described in paragraph (c) of this section;

(3) The cost plus method, described in paragraph (d) of this section;

(4) The comparable profits method, described in § 1.482–5;

be made in accordance with the rules of this paragraph.

(c) *Use of tangible property*—(1) *General rule.* Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in paragraph (c)(2)(i) of this section) the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) *Arm's length charge*—(i) *In general.* For purposes of paragraph (c) of this section, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

(ii) *Safe haven rental charge.* See §1.482–2(c)(2)(ii) (26 CFR Part 1 revised as of April 1, 1985), for the determination of safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(iii) *Subleases*—(A) Except as provided in paragraph (c)(2)(iii)(B) of this section, where possession, use, or occupancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period. Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(B) The provisions of paragraph (c)(2)(iii)(A) of this section shall not apply if either—

(*1*) The taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (c)(2)(i) of this section; or

(*2*) During the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the same general type as the property in question to unrelated persons.

(d) *Transfer of property.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving the transfer of property, see §§1.482–3 through 1.482–6.

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(a) *In general.* The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the six methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of §1.482–1, including the best method rule of §1.482–1(c), the comparability analysis of §1.482–1(d), and the arm's length range of §1.482–1(e). The methods are—

(1) The comparable uncontrolled price method, described in paragraph (b) of this section;

(2) The resale price method, described in paragraph (c) of this section;

(3) The cost plus method, described in paragraph (d) of this section;

(4) The comparable profits method, described in §1.482–5;

(5) The profit split method, described in § 1.482–6; and

(6) Unspecified methods, described in paragraph (e) of this section.

(b) *Comparable uncontrolled price method*—(1) *In general.* The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in § 1.482–1(c). The application of these factors under the comparable uncontrolled price method is discussed in paragraph (b)(2)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of § 1.482–1(d). Although all of the factors described in § 1.482–1(d)(3) must be considered, similarity of products generally will have the greatest effect on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material product differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(B) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of § 1.482–1(d)(2). Specific examples of the factors that may be particularly relevant to this method include—

(*1*) Quality of the product;

(*2*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(*3*) Level of the market (i.e., wholesale, retail, etc.);

(*4*) Geographic market in which the transaction takes place;

(*5*) Date of the transaction;

(*6*) Intangible property associated with the sale;

(*7*) Foreign currency risks; and

(*8*) Alternatives realistically available to the buyer and seller.

(iii) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482–1(c) (Best method rule).

(3) *Arm's length range.* See § 1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Comparable Sales of Same Product. USM, a U.S. manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. USM's factory. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. Because USM sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result. See §1.482–3(b)(2)(ii)(A).

Example 2. Effect of Trademark. The facts are the same as in *Example 1,* except that USM affixes its valuable trademark to the property sold in the controlled transactions, but does not affix its trademark to the property sold in the uncontrolled transactions. Under the facts of this case, the effect on price of the trademark is material and cannot be reliably estimated. Because there are material product differences for which reliable adjustments cannot be made, the comparable uncontrolled price method is unlikely to provide a reliable measure of the arm's length result. See §1.482–3(b)(2)(ii)(A).

Example 3. Minor Product Differences. The facts are the same as in *Example 1,* except that USM, which manufactures business machines, makes minor modifications to the physical properties of the machines to satisfy specific requirements of a customer in controlled sales, but does not make these modifications in uncontrolled sales. If the minor physical differences in the product have a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of §1.482- 1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

Example 4. Effect of Geographic Differences. FM, a foreign specialty radio manufacturer, sells its radios to a controlled U.S. distributor, AM, that serves the West Coast of the United States. FM sells its radios to uncontrolled distributors to serve other regions in the United States. The product in the controlled and uncontrolled transactions is the same, and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same, other than the geographic differences. If the geographic differences are unlikely to have a material effect on price, or they have definite and reasonably ascertainable effects for which adjustments are made, then the adjusted results of the uncontrolled sales may be used under the comparable uncontrolled price method to establish an arm's length range pursuant to §1.482–1(e)(2)(iii)(A). If the effects of the geographic differences would be material but cannot be reliably ascertained, then the reliability of the results will be diminished. However, the comparable uncontrolled price method may still provide the most reliable measure of an arm's length result, pursuant to the best method rule of §1.482–1(c), and, if so, an arm's length range may be established pursuant to §1.482–1(e)(2)(iii)(B).

(5) *Indirect evidence of comparable uncontrolled transactions*—(i) *In general.* A comparable uncontrolled price may be derived from data from public exchanges or quotation media, but only if the following requirements are met—

(A) The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;

(B) The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used by uncontrolled taxpayers in the industry; and

(C) The amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by uncontrolled taxpayers.

(ii) *Limitation.* Use of data from public exchanges or quotation media may not be appropriate under extraordinary market conditions.

(iii) *Examples.* The following examples illustrate this paragraph (b)(5).

Example 1. Use of Quotation Medium. (i) On June 1, USOil, a United States corporation, enters into a contract to purchase crude oil from its foreign subsidiary, FS, in Country Z. USOil and FS agree to base their sales price on the average of the prices published for that crude in a quotation medium in the five days before August 1, the date set for delivery. USOil and FS agree to adjust the price for the particular circumstances of their transactions, including the quantity of the crude sold, contractual terms, transportation costs, risks borne, and other factors that affect the price.

(ii) The quotation medium used by USOil and FS is widely and routinely used in the ordinary course of business in the industry to establish prices for uncontrolled sales. Because USOil and FS use the data to set their sales price in the same way that unrelated parties use the data from the quotation medium to set their sales prices, and appropriate adjustments were made to account for differences, the price derived from the quotation medium used by USOil and FS to set their transfer prices will be considered evidence of a comparable uncontrolled price.

Example 2. Extraordinary Market Conditions. The facts are the same as in *Example 1,* except that before USOil and FS enter into their contract, war breaks out in Countries X and Y, major oil producing countries, causing significant instability in world petroleum markets. As a result, given the significant instability in the price of oil, the prices listed on the quotation medium may not reflect a reliable measure of an arm's length result. See §1.482–3(b)(5)(ii).

(c) *Resale price method*—(1) *In general.* The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale. For this purpose, packaging, repackaging, labelling, or minor assembly do not ordinarily constitute physical alteration. Further the resale price method is not ordinarily used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods.

(2) *Determination of arm's length price*—(i) *In general.* The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review.

(ii) *Applicable resale price.* The applicable resale price is equal to either the resale price of the particular item of property involved or the price at which contemporaneous resales of the same property are made. If the property purchased in the controlled sale is resold to one or more related parties in a series of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the property is resold to an uncontrolled party, or the price at which contemporaneous resales of the same property are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the group participating in the series of controlled sales and final uncontrolled resales, as well as any other relevant factors described in §1.482–1(d)(3).

(iii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions.

(iv) *Arm's length range.* See §1.482–1(e)(2) for determination of the arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c). The application of these factors under the resale price method is discussed in paragraphs (c)(3) (ii) and (iii) of this section.

(ii) *Comparability*—(A) *Functional comparability*. The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of §1.482–1(d). A reseller's gross profit provides compensation for the performance of resale functions related to the product or products under review, including an operating profit in return for the reseller's investment of capital and the assumption of risks. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. For example, distributors of a wide variety of consumer durables might perform comparable distribution functions without regard to the specific durable goods distributed. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve the distribution of products of the same general type (e.g., consumer electronics). Furthermore, significant differences in the value of the distributed goods due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit margin, adjustments should be made to the gross profit margin earned with respect to the uncontrolled transaction according to the comparability provisions of §1.482–1(d)(2). For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) Inventory levels and turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;

(*2*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(*3*) Sales, marketing, advertising programs and services, (including promotional programs, rebates, and co-op advertising);

(*4*) The level of the market (e.g., wholesale, retail, etc.); and

(*5*) Foreign currency risks.

(D) *Sales agent.* If the controlled taxpayer is comparable to a sales agent that does not take title to goods or otherwise assume risks with respect to ownership of such goods, the commission earned by such sales agent, expressed as a percentage of the uncontrolled sales price of the goods involved, may be used as the comparable gross profit margin.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the resale price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit margin affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit margin, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the uncontrolled comparable should be consistent in the reporting of items (such as discounts, returns and allowances, rebates, transportation costs, insurance, and packaging) between cost of goods sold and operating expenses.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. A controlled taxpayer sells property to another member of its controlled group that resells the property in uncontrolled sales. There are no changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale is a price of $80 ($100 minus (20%×$100)).

Example 2. (i) S, a U.S. corporation, is the exclusive distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. S's total reported cost of goods sold is $800, consisting of $600 for property purchased from FP and $200 of other costs of goods sold incurred to unrelated parties. S's applicable resale price and reported gross profit are as follows:

Applicable resale price	$1000
Cost of goods sold:	
Cost of purchases from FP	600
Costs incurred to unrelated parties	200
Reported gross profit	200

(ii) The district director determines that the appropriate gross profit margin is 25%. Therefore, S's appropriate gross profit is $250 (i.e., 25% of the applicable resale price of $1000). Because S is incurring costs of sales to unrelated parties, an arm's length price for property purchased from FP must be determined under a two-step process. First, the appropriate gross profit ($250) is subtracted from the applicable resale price ($1000). The resulting amount ($750) is then reduced by the costs of sales incurred to unrelated parties ($200). Therefore, an arm's length price for S's cost of sales of FP's product in this case equals $550 (i.e., $750 minus $200).

Example 3. FP, a foreign manufacturer, sells Product to USSub, its U.S. subsidiary, which in turn sells Product to its domestic affiliate Sister. Sister sells Product to unrelated buyers. In this case, the applicable resale price is the price at which Sister sells Product in uncontrolled transactions. The determination of the appropriate gross profit margin for the sale from FP to USSub will take into account the functions performed by USSub and Sister, as well as other relevant factors described in §1.482–1(d)(3).

Example 4. USSub, a U.S. corporation, is the exclusive distributor of widgets for its foreign parent. To determine whether the gross profit margin of 25% earned by USSub is an arm's length result, the district director considers applying the resale price method. There are several uncontrolled distributors that perform similar functions under similar circumstances in uncontrolled transactions. However, the uncontrolled distributors treat certain costs such as discounts and insurance as cost of goods sold, while USSub treats such costs as operating expenses. In such cases, accounting reclassifications, pursuant to §1.482–3(c)(3)(iii)(B), must be made to ensure consistent treatment of such material items. Inability to make such accounting reclassifications will decrease the reliability of the results of the uncontrolled transactions.

Example 5. (i) USP, a U.S. corporation, manufactures Product X, an unbranded widget, and sells it to FSub, its wholly owned foreign subsidiary. FSub acts as a distributor of Product X in country M, and sells it to uncontrolled parties in that country. Uncontrolled distributors A, B, C, D, and E distribute competing products of approximately similar value in country M. All such products are unbranded.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled distributors and the contractual terms under which they operate in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled distributors and FSub. Because the available data is sufficiently complete and accurate to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, such differences have a definite and reasonably ascertainable effect, and reliable adjustments are made to account for such differences, the results of each of the uncontrolled distributors may be used to establish an arm's length range pursuant to §1.482–1(e)(2)(iii)(A).

Example 6. The facts are the same as *Example 5,* except that sufficient data is not available to determine whether any of the uncontrolled distributors provide warranties or to determine the payment terms of the contracts. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether these differences exist between the controlled and uncontrolled transactions diminishes the reliability of the results of the uncontrolled comparables. However, the reliability of the results may be enhanced by the application of a statistical method when establishing an arm's length range pursuant to §1.482–1(e)(2)(iii)(B).

Example 7. The facts are the same as in *Example 5,* except that Product X is branded with a valuable trademark that is owned by

P. A, B, and C distribute unbranded competing products, while D and E distribute products branded with other trademarks. D and E do not own any rights in the trademarks under which their products are sold. The value of the products that A, B, and C sold are not similar to the value of the products sold by S. The value of products sold by D and E, however, is similar to that of Product X. Although close product similarity is not as important for a reliable application of the resale price method as for the comparable uncontrolled price method, significant differences in the value of the products involved in the controlled and uncontrolled transactions may affect the reliability of the results. In addition, because in this case it is difficult to determine the effect the trademark will have on price or profits, reliable adjustments for the differences cannot be made. Because D and E have a higher level of comparability than A, B, and C with respect to S, pursuant to §1.482–1(e)(2)(ii), only D and E may be included in an arm's length range.

(d) *Cost plus method*—(1) *In general.* The cost plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The cost plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.

(2) *Determination of arm's length price*—(i) *In general.* The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction.

(ii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.

(iii) *Arm's length range.* See §1.482–1(e)(2) for determination of an arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c).

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of §1.482–1(d). A producer's gross profit provides compensation for the performance of the production functions related to the product or products under review, including an operating profit for the producer's investment of capital and assumption of risks. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers. In the absence of such sales, an appropriate gross profit markup may be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions involve the production of goods within the same product categories. Furthermore, significant differences in the value of the products due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the comparable uncontrolled transaction according to the provisions of §1.482–1(d)(2). For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

(*1*) The complexity of manufacturing or assembly;

(*2*) Manufacturing, production, and process engineering;

(*3*) Procurement, purchasing, and inventory control activities;

(*4*) Testing functions;

(*5*) Selling, general, and administrative expenses;

(*6*) Foreign currency risks; and

(*7*) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms).

(D) *Purchasing agent.* If a controlled taxpayer is comparable to a purchasing agent that does not take title to property or otherwise assume risks with respect to ownership of such goods, the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may be used as the appropriate gross profit markup.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the cost plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit markup affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the comparable uncontrolled transaction should be consistent in the reporting of costs between cost of goods sold and operating expenses. The term *cost of producing* includes the cost of acquiring property that is held for resale.

(4) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. (i) USP, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. UT1, UT2, and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers.

(ii) Relatively complete data is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled manufacturers and USP. Because the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, the effect of the differences are definite and reasonably ascertainable, and reliable adjustments are made to account for the differences, an arm's length range can be established pursuant to §1.482–1(e)(2)(iii)(A).

Example 2. The facts are the same as in *Example 1,* except that USP accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit markups of UT1, UT2, and UT3, however, reflect supervisory, general, and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit markups of UT1, UT2, and UT3 must be adjusted as provided in paragraph (d)(3)(iii)(B) of this section to provide accounting consistency. If data is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions, the reliability of the results will be decreased.

Example 3. The facts are the same as in *Example 1,* except that under its contract with FS, USP uses materials consigned by FS. UT1, UT2, and UT3, on the other hand, purchase their own materials, and their gross profit markups are determined by including the costs of materials. The fact that USP does not carry an inventory risk by purchasing its own materials while the uncontrolled producers carry inventory is a significant difference that may require an adjustment if the difference has a material effect on the gross profit markups of the uncontrolled producers. Inability to reasonably ascertain the effect of the difference on the gross profit markups will affect the reliability of the results of UT1, UT2, and UT3.

Example 4. (i) FS, a foreign corporation, produces apparel for USP, its U.S. parent corporation. FS purchases its materials from unrelated suppliers and produces the apparel according to designs provided by USP. The district director identifies 10 uncontrolled foreign apparel producers that operate in the same geographic market and are similar in many respect to FS.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled producers. In addition, data is sufficiently detailed to permit adjustments for differences in accounting practices. However, sufficient data is not available to determine whether it is likely that all material differences in contractual terms have been identified. For example, it is not possible to determine which parties in the uncontrolled transactions bear currency risks. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether differences exist between the controlled and uncontrolled transactions will diminish the reliability of these results. Therefore, the reliability of the results of the uncontrolled transactions must be enhanced by the application of a statistical method in establishing an arm's length range pursuant to § 1.482–1(e)(2)(iii)(B).

(e) *Unspecified methods*—(1) *In general.* Methods not specified in paragraphs (a)(1), (2), (3), (4), and (5) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (e) must be applied in accordance with the provisions of § 1.482–1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed 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 choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482–1(c). Therefore, in accordance with § 1.482–1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (e).

Example. Amcan, a U.S. company, produces unique vessels for storing and transporting toxic waste, toxicans, at its U.S. production facility. Amcan agrees by contract to supply its Canadian subsidiary, Cancan, with 4000 toxicans per year to serve the Canadian market for toxicans. Prior to entering into the contract with Cancan, Amcan had received a bona fide offer from an independent Canadian waste disposal company, Cando, to serve as the Canadian distributor for toxicans and to purchase a similar number of toxicans at a price of $5,000 each. If the circumstances and terms of the Cancan supply contract are sufficiently similar to those of the Cando offer, or sufficiently reliable adjustments can be made for differences between them, then the Cando offer price of

$5,000 may provide reliable information indicating that an arm's length consideration under the Cancan contract will not be less than $5,000 per toxican.

(f) *Coordination with intangible property rules.* The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property (embedded intangible). Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. Pursuant to § 1.482–1(d)(3)(v), however, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. For example, because product comparability has the greatest effect on an application of the comparable uncontrolled price method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method. The effect of embedded intangibles on comparability will be determined under the principles of § 1.482–4. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property), it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property under § 1.482–4. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, then the arm's length consideration for the transfer of that right must be determined separately under § 1.482–4.

[T.D. 8552, 59 FR 35011, July 8, 1994; 60 FR 16382, Mar. 30, 1995]

§ 1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of § 1.482–1, including the best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e). The arm's length consideration for the transfer of an intangible determined under this section must be commensurate with the income attributable to the intangible. See § 1.482–4(f)(2) (Periodic adjustments). The available methods are—

(1) The comparable uncontrolled transaction method, described in paragraph (c) of this section;

(2) The comparable profits method, described in § 1.482–5;

(3) The profit split method, described in § 1.482–6; and

(4) Unspecified methods described in paragraph (d) of this section.

(b) *Definition of intangible.* For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual—

(1) Patents, inventions, formulae, processes, designs, patterns, or knowhow;

(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. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

(c) *Comparable uncontrolled transaction method*—(1) *In general.* The comparable uncontrolled transaction method evaluates whether the amount

$5,000 may provide reliable information indicating that an arm's length consideration under the Cancan contract will not be less than $5,000 per toxican.

(f) *Coordination with intangible property rules.* The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property (embedded intangible). Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. Pursuant to § 1.482–1(d)(3)(v), however, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. For example, because product comparability has the greatest effect on an application of the comparable uncontrolled price method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method. The effect of embedded intangibles on comparability will be determined under the principles of § 1.482–4. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property), it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property under § 1.482–4. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, then the arm's length consideration for the transfer of that right must be determined separately under § 1.482–4.

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§ 1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of § 1.482–1, including the best method rule of § 1.482–1(c), the comparability analysis of § 1.482–1(d), and the arm's length range of § 1.482–1(e). The arm's length consideration for the transfer of an intangible determined under this section must be commensurate with the income attributable to the intangible. See § 1.482–4(f)(2) (Periodic adjustments). The available methods are—

(1) The comparable uncontrolled transaction method, described in paragraph (c) of this section;

(2) The comparable profits method, described in § 1.482–5;

(3) The profit split method, described in § 1.482–6; and

(4) Unspecified methods described in paragraph (d) of this section.

(b) *Definition of intangible.* For purposes of section 482, an intangible is an asset that comprises any of the following items and has 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. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

(c) *Comparable uncontrolled transaction method*—(1) *In general.* 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. The amount determined under this method may be adjusted as required by paragraph (f)(2) of this section (Periodic adjustments).

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of an arm's length result is determined using the factors described under the best method rule in § 1.482–1(c). The application of these factors under the comparable uncontrolled transaction method is discussed in paragraphs (c)(2)(ii), (iii), and (iv) of this section.

(ii) *Reliability*. If an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled transactions cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.

(iii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of § 1.482–1(d). Although all of the factors described in § 1.482–1(d)(3) must be considered, specific factors may be particularly relevant to this method. In particular, the application of this method requires that the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property, as defined in paragraph (c)(2)(iii)(B)(*1*) of this section. In addition, because differences in contractual terms, or the economic conditions in which transactions take place, could materially affect the amount charged, comparability under this method also depends on similarity with respect to these factors, or adjustments to account for material differences in such circumstances.

(B) *Factors to be considered in determining comparability*—(*1*) *Comparable intangible property*. In order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangibles must—

(*i*) Be used in connection with similar products or processes within the same general industry or market; and

(*ii*) Have similar profit potential. The profit potential of an intangible is most reliably measured by directly calculating the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. If the information necessary to directly calculate net present value of the benefits to be realized is unavailable, and the need to reliably measure profit potential is reduced because the potential profits are relatively small in terms of total amount and rate of return, comparison of profit potential may be based upon the factors referred to in paragraph (c)(2)(iii)(B)(*2*) of this section. See *Example 3* of § 1.482–4(c)(4). Finally, the reliability of a measure of profit potential is affected by the extent to which the profit attributable to the intangible can be isolated from the profit attributable to other factors, such as functions performed and other resources employed.

(*2*) *Comparable circumstances.* In evaluating the comparability of the circumstances of the controlled and uncontrolled transactions, although all of the factors described in §1.482–1(d)(3) must be considered, specific factors that may be particularly relevant to this method include the following—

(*i*) The terms of the transfer, including the exploitation rights granted in the intangible, 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;

(*ii*) The stage of development of the intangible (including, where appropriate, necessary governmental approvals, authorizations, or licenses) in the market in which the intangible is to be used;

(*iii*) Rights to receive updates, revisions, or modifications of the intangible;

(*iv*) The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries;

(*v*) The duration of the license, contract, or other agreement, and any termination or renegotiation rights;

(*vi*) Any economic and product liability risks to be assumed by the transferee;

(*vii*) The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor; and

(*viii*) The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

(iv) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled transaction method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482–1(c) (Best method rule).

(3) *Arm's length range.* See §1.482–1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that 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 foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses 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 protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement.

Example 2. The facts are the same as in *Example 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 drug Z is likely to be much higher in country Y than it is in Country X. Consequently, the Ydrug license agreement is unlikely to provide a reliable measure of the arm's length royalty rate for the Xpharm license.

Example 3. (i) 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 FP's equipment and some of them have distinctive features, but other companies produce similar components and none of these components by itself accounts for a substantial part of the value of FP's products.

(ii) FP licenses its U.S. subsidiary, USSub, exclusive North American rights to use the patented technology for producing component X, 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 USSub's products and to assist with initial production. Under the terms of the license agreement USSub pays FP a royalty equal to 3 percent of sales of USSub equipment incorporating component X.

(iii) FP does not license unrelated parties to use component X, but many similar components are transferred between uncontrolled taxpayers. Consequently, the district director decides to apply the comparable uncontrolled transaction method to evaluate whether the 3 percent royalty for component X is an arm's length royalty.

(iv) The district director uses a database of company documents filed with the Securities and Exchange Commission (SEC) to identify potentially comparable license agreements between uncontrolled taxpayers that are on file with the SEC. The district director identifies 40 license agreements that were entered into in the same year as the controlled transfer or in the prior or following year, and that relate to transfers of technology associated with industrial equipment that has similar applications to USSub's products. Further review of these uncontrolled agreements indicates that 25 of them 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.

(v) The district director makes a detailed review of the terms of each of the 25 uncontrolled agreements and finds that 15 of them are similar to the controlled agreement in that they all involve—

(A) The transfer of exclusive rights for the North American market;

(B) 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;

(C) The transfer of patented technology;

(D) Continuing technical support;

(E) Access to technical improvements;

(F) Technology of a similar age; and

(G) A similar duration of the agreement.

(vi) Based on these factors and the fact that none of the components to which these license agreements relate accounts for a substantial part of the value of the final products, the district director concludes that these fifteen intangibles have similar profit potential to the component X technology.

(vii) The 15 uncontrolled comparables produce the following royalty rates:

License	Royalty rate (percent)
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

(viii) Although the uncontrolled comparables are clearly similar to the controlled transaction, it is likely that unidentified material differences exist between the uncontrolled comparables and the controlled transaction. Therefore, an appropriate statistical technique must be used to establish the arm's length range. In this case the district director uses the interquartile range to determine the arm's length range. Therefore, the arm's length range covers royalty rates from 1.25 to 2.5 percent, and an adjustment is warranted to the 3 percent royalty charged in the controlled transfer. The district director determines that the appropriate adjustment corresponds to a reduction in the royalty rate to 2.0 percent, which is the median of the uncontrolled comparables.

Example 4. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that 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, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit in the European market. In setting the royalty rate for this 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 license agreements are closely comparable. The drugs were licensed at the same stage in their development and the 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. Thus, USdrug concludes that the profit potential of Lessplit is not similar to the profit potential of Nosplit, and the Lessplit license agreement consequently is not a comparable uncontrolled transaction for purposes of this paragraph (c) in spite of the other indicia of comparability between the two intangibles.

(d) *Unspecified methods*—(1) *In general.* Methods not specified in paragraphs (a)(1), (2), and (3) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (d) must be applied in accordance with the provisions of § 1.482–1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled transaction 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 choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482–1(c). Therefore, in accordance with § 1.482–1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (d).

Example. (i) USbond is a U.S. company that licenses to its foreign subsidiary, Eurobond, a proprietary process that permits the manufacture of Longbond, a long-lasting industrial adhesive, at a substantially lower cost than otherwise would be possible. Using the proprietary process, Eurobond manufactures Longbond and sells it to related and unrelated parties for the market price of $550 per ton. Under the terms of the license agreement, Eurobond pays USbond a royalty of $100 per ton of Longbond sold. USbond also manufactures and markets Longbond in the United States.

(ii) In evaluating whether the consideration paid for the transfer of the proprietary process to Eurobond was arm's length, the district director may consider, subject to the best method rule of § 1.482–1(c), USbond's alternative of producing and selling Longbond itself. Reasonably reliable estimates indicate that if USbond directly supplied Longbond to the European market, a selling price of $300 per ton would cover its costs and provide a reasonable profit for its functions, risks and investment of capital associated with the production of Longbond for the European market. Given that the market price of Longbond was $550 per ton, by licensing the proprietary process to Eurobond, USbond forgoes $250 per ton of profit over the profit that would be necessary to compensate it for the functions, risks and investment involved in supplying Longbond to the European market itself. Based on these facts, the district director concludes that a royalty of $100 for the proprietary process is not arm's length.

(e) *Coordination with tangible property rules.* See § 1.482–3(f) for the provisions regarding the coordination between the tangible property and intangible property rules.

(f) *Special rules for transfers of intangible property*—(1) *Form of consideration.* If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

(2) *Periodic adjustments*—(i) General rule. If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to

the intangible. Adjustments made pursuant to this paragraph (f)(2) shall be consistent with the arm's length standard and the provisions of § 1.482–1. In determining whether to make such adjustments in the taxable year under examination, the district director may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the district director in a subsequent taxable year from making an adjustment to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of section 482 may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes. For exceptions to this rule see paragraph (f)(2)(ii) of this section.

(ii) *Exceptions*—(A) *Transactions involving the same intangible.* If the same intangible was transferred to an uncontrolled taxpayer under substantially the same circumstances as those of the controlled transaction; this transaction serves as the basis for the application of the comparable uncontrolled transaction method in the first taxable year in which substantial periodic consideration was required to be paid; and the amount paid in that year was an arm's length amount, then no allocation in a subsequent year will be made under paragraph (f)(2)(i) of this paragraph for a controlled transfer of intangible property.

(B) *Transactions involving comparable intangible.* If the arm's length result is derived from the application of the comparable uncontrolled transaction method based on the transfer of a comparable intangible under comparable circumstances to those of the controlled transaction, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(*1*) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under review;

(*2*) There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's length consideration (uncontrolled agreement), which contains no provisions that would permit any change to the amount of consideration, a renegotiation, or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contains provisions permitting only specified, non-contingent, periodic changes to the amount of consideration);

(*3*) The controlled agreement is substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective and the provisions described in paragraph (f)(2)(ii)(B)(*2*) of this section;

(*4*) The controlled agreement limits use of the intangible to a specified field or purpose in a manner that is consistent with industry practice and any such limitation in the uncontrolled agreement;

(*5*) There were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and

(*6*) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established under paragraph (c)(2) of this section.

(C) *Methods other than comparable uncontrolled transaction.* If the arm's length amount was determined under any method other than the comparable uncontrolled transaction method, no allocation will be made under paragraph (f)(2)(i) of this section if each of the following facts is established—

(*1*) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, and such agreement remained in effect for the taxable year under review;

(*2*) The consideration called for in the controlled agreement was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with the execution of the controlled agreement;

(*3*) There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable; and

(*4*) The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into.

(D) *Extraordinary events.* No allocation will be made under paragraph (f)(2)(i) of this section if the following requirements are met—

(*1*) Due to extraordinary events that were beyond the control of the controlled taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into, the aggregate actual profits or aggregate cost savings realized by the taxpayer are less than 80% or more than 120% of the prospective profits or cost savings; and

(*2*) All of the requirements of paragraph (f)(2)(ii) (B) or (C) of this section are otherwise satisfied.

(E) *Five-year period.* If the requirements of §1.482–4 (f)(2)(ii)(B) or (f)(2)(ii)(C) are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid, then no periodic adjustment will be made under paragraph (f)(2)(i) of this section in any subsequent year.

(iii) *Examples.* The following examples illustrate this paragraph (f)(2).

Example 1. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. and European markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit for the European market for 5 years. In setting the royalty rate for this license, USdrug makes projections of the annual sales revenue and the annual profits to be derived from the exploitation of Nosplit by Eurodrug. Based on the projections, a royalty rate of 3.9% is established for the term of the license.

(iii) In Year 1, USdrug evaluates the royalty rate it received from Eurodrug. Given the high profit potential of Nosplit, USdrug is unable to locate any uncontrolled transactions dealing with licenses of comparable intangible property. USdrug therefore determines that the comparable uncontrolled transaction method will not provide a reliable measure of an arm's length royalty. However, applying the comparable profits method to Eurodrug, USdrug determines that a royalty rate of 3.9% will result in Eurodrug earning an arm's length return for its manufacturing and marketing functions.

(iv) In Year 5, the U.S. income tax return for USdrug is examined, and the district director must determine whether the royalty rate between USdrug and Eurodrug is commensurate with the income attributable to Nosplit. In making this determination, the district director considers whether any of the exceptions in §1.482–4(f)(2)(ii) are applicable. In particular, the district director compares the profit projections attributable to Nosplit made by USdrug against the actual profits realized by Eurodrug. The projected and actual profits are as follows:

	Profit projections	Actual profits
Year 1	200	250
Year 2	250	300
Year 3	500	600
Year 4	350	200
Year 5	100	100
Total	1400	1450

(v) The total profits earned through Year 5 were not less than 80% nor more than 120% of the profits that were projected when the license was entered into. If the district director determines that the other requirements of § 1.482–4(f)(2)(ii)(C) were met, no adjustment will be made to the royalty rate between USdrug and Eurodrug for the license of Nosplit.

Example 2. (i) The facts are the same as in *Example 1,* except that Eurodrug's actual profits earned were much higher than the projected profits, as follows:

	Profit projections	Actual profits
Year 1	200	250
Year 2	250	500
Year 3	500	800
Year 4	350	700
Year 5	100	600
Total	1400	2850

(ii) In examining USdrug's tax return for Year 5, the district director considers the actual profits realized by Eurodrug in Year 5, and all past years. Accordingly, although Years 1 through 4 may be closed under the statute of limitations, for purposes of determining whether an adjustment should be made with respect to the royalty rate in Year 5 with respect to Nosplit, the district director aggregates the actual profits from those years with the profits of Year 5. However, the district director will make an adjustment, if any, only with respect to Year 5.

Example 3. (i) FP, a foreign corporation, licenses to USS, its U.S. subsidiary, a new air-filtering process that permits manufacturing plants to meet new environmental standards. The license runs for a 10-year period, and the profit derived from the new process is projected to be $15 million per year, for an aggregate profit of $150 million.

(ii) The royalty rate for the license is based on a comparable uncontrolled transaction involving a comparable intangible under comparable circumstances. The requirements of paragraphs (f)(2)(ii)(B)(*1*) through (*5*) of this section have been met. Specifically, FP and USS have entered into a written agreement that provides for a royalty in each year of the license, the royalty rate is considered arm's length for the first taxable year in which a substantial royalty was required to be paid, the license limited the use of the process to a specified field, consistent with industry practice, and there are no substantial changes in the functions performed by USS after the license was entered into.

(iii) In examining Year 4 of the license, the district director determines that the aggregate actual profits earned by USS through Year 4 are $30 million, less than 80% of the projected profits of $60 million. However, USS establishes to the satisfaction of the district director that the aggregate actual profits from the process are less than 80% of the projected profits in Year 3 because an earthquake severely damaged USS's manufacturing plant. Because the difference between the projected profits and actual profits was due to an extraordinary event that was beyond the control of USS, and could not reasonably have been anticipated at the time the license was entered into, the requirement under § 1.482–4(f)(2)(ii)(D) has been met, and no adjustment under this section is made.

(3) *Ownership of intangible property*—(i) *In general.* If the owner of the rights to exploit an intangible transfers such rights to a controlled taxpayer, the owner must receive an amount of consideration with respect to such transfer that is determined in accordance with the provisions of this section. If another controlled taxpayer provides assistance to the owner in connection with the development or enhancement of an intangible, such person may be entitled to receive consideration with respect to such assistance. See § 1.482–4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). Because the right to exploit an intangible can be subdivided in various ways, a single intangible may have multiple owners for purposes of this paragraph (3)(i). Thus, for example, the owner of a trademark may license to another person the exclusive right to use that trademark in a specified geographic area for a specified period of time (while otherwise retaining the right to use the intangible). In such a case, both the licensee and the licensor will be considered owners for purposes of this paragraph (f)(3)(i), with respect to their respective exploitation rights.

(ii) *Identification of owner*—(A) *Legally protected intangible property.* The legal owner of a right to exploit an intangible ordinarily will be considered the owner for purposes of this section. Legal ownership may be acquired by operation of law or by contract under which the legal owner transfers all or part of its rights to another. Further, the district director may impute an agreement to convey legal ownership if the conduct of the controlled taxpayers indicates the existence in substance of such an agreement. See § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms).

(B) *Intangible property that is not legally protected.* In the case of intangible property that is not legally protected, the developer of the intangible will be considered the owner. Except as provided in § 1.482–7T, if two or more controlled taxpayers jointly develop an intangible, for purposes of section 482, only one of the controlled taxpayers will be regarded as the developer and owner of the intangible, and the other participating members will be regarded as assisters. Ordinarily, the developer is the controlled taxpayer that bore the largest portion of the direct and indirect costs of developing the intangible, including the provision, without adequate compensation, of property or services likely to contribute substantially to developing the intangible. A controlled taxpayer will be presumed not to have borne the costs of development if, pursuant to an agreement entered into before the success of the project is known, another person is obligated to reimburse the controlled taxpayer for its costs. If it cannot be determined which controlled taxpayer bore the largest portion of the costs of development, all other facts and circumstances will be taken into consideration, including the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer controls the project, and the conduct of the controlled taxpayers.

(iii) *Allocations with respect to assistance provided to the owner.* Allocations may be made to reflect an arm's length consideration for assistance provided to the owner of an intangible in connection with the development or enhancement of the intangible. Such assistance may include loans, services, or the use of tangible or intangible property. Assistance does not, however, include expenditures of a routine nature that an unrelated party dealing at arm's length would be expected to incur under circumstances similar to those of the controlled taxpayer. The amount of any allocation required with respect to that assistance must be determined in accordance with the applicable rules under section 482.

(iv) *Examples.* The principles of this paragraph are illustrated by the following examples.

Example 1. A, a member of a controlled group, allows B, another member of the controlled group and the owner of an intangible, to use tangible property, such as laboratory equipment, in connection with the development of the intangible. Any allocations with respect to the owner's use of the property will be determined under § 1.482–2(c).

Example 2. FP, a foreign producer of cheese, markets the cheese in countries other than the United States under the tradename Fromage Frere. FP owns all the worldwide rights to this name. The name is widely known and is valuable outside the United States but is not known within the United States. In 1995, FP decides to enter the United States market and incorporates U.S. subsidiary, USSub, to be its U.S. distributor and to supervise the advertising and other marketing efforts that will be required to develop the name Fromage Frere in the United States. USSub incurs expenses that are not reimbursed by FP for developing the U.S. market for Fromage Frere. These expenses are comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry when introducing a product in the U.S. market under a brand name owned by a foreign manufacturer. Since USSub would have been expected to incur these expenses if it were unrelated to FP, no allocation to USSub is made with respect to the market development activities performed by USSub.

Example 3. The facts are the same as in *Example 2,* except that the expenses incurred by USSub are significantly larger than the expenses incurred by independent distributors under similar circumstances. FP does not reimburse USSub for its expenses. The district director concludes based on this evidence that an unrelated party dealing at arm's length under similar circumstances would not have engaged in the same level of activity relating to the development of FP's marketing intangibles. The expenditures in excess of the level incurred by the independent distributors therefore are considered to be a service provided to FP that adds to the value of FP's trademark for Fromage Frere. Accordingly, the district director makes an allocation under section 482 for the fair market value of the services that USSub is considered to have performed for FP.

Example 4. The facts are the same as in *Example 3,* except that FP and USSub conclude a long term agreement under which USSub receives the exclusive right to distribute cheese in the United States under FP's trademark. USSub purchases cheese from FP at an arm's length price. Since USSub is the owner of the trademark under paragraph (f)(3)(ii)(A) of this section, and its conduct is consistent with that status, its activities related to the development of the trademark are not considered to be a service performed for the benefit of FP, and no allocation is made with respect to such activities.

(4) *Consideration not artificially limited.* The arm's length consideration for the controlled transfer of an intangible is not limited by the consideration paid in any uncontrolled transactions that do not meet the requirements of the comparable uncontrolled transaction method described in paragraph (c) of this section. Similarly, the arm's length consideration for an intangible is not limited by the prevailing rates of consideration paid for the use or transfer of intangibles within the same or similar industry.

(5) *Lump sum payments*—(i) *In general.* If an intangible is transferred in a controlled transaction for a lump sum, that amount must be commensurate with the income attributable to the intangible. A lump sum is commensurate with income in a taxable year if the equivalent royalty amount for that taxable year is equal to an arm's length royalty. The equivalent royalty amount for a taxable year is the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible (or the period covered by an agreement, if shorter), taking into account the projected sales of the licensee as of the date of the transfer. Thus, determining the equivalent royalty amount requires a present value calculation based on the lump sum, an appropriate discount rate, and the projected sales over the relevant period. The equivalent royalty amount is subject to periodic adjustments under § 1.482–4(f)(2)(i) to the same extent as an actual royalty payment pursuant to a license agreement.

(ii) *Exceptions.* No periodic adjustment will be made under paragraph (f)(2)(i) of this section if any of the exceptions to periodic adjustments provided in paragraph (f)(2)(ii) of this section apply.

(iii) *Example.* The following example illustrates the principle of this paragraph (f)(5).

Example. Calculation of the equivalent royalty amount. (i) FSub is the foreign subsidiary of USP, a U.S. company. USP licenses FSub the right to produce and sell the whopperchopper, a patented new kitchen appliance, for the foreign market. The license is for a period of five years, and payment takes the form of a single lump-sum charge of $500,000 that is paid at the beginning of the period.

(ii) The equivalent royalty amount for this license is determined by deriving an equivalent royalty rate equal to the lump-sum payment divided by the present discounted value of FSub's projected sales of whopperchoppers over the life of the license. Based on the riskiness of the whopperchopper business, an appropriate discount rate is determined to be 10 percent. Projected sales of whopperchoppers for each year of the license are as follows:

Year	Projected sales
1	$2,500,000
2	2,600,000
3	2,700,000
4	2,700,000
5	2,750,000

(iii) Based on this information, the present discounted value of the projected whopperchopper sales is approximately $10 million, yielding an equivalent royalty rate of approximately 5%. Thus, the equivalent royalty amounts for each year are as follows:

Year	Projected sales	Equivalent royalty amount
1	$2,500,000	$125,000
2	2,600,000	130,000
3	2,700,000	135,000
4	2,700,000	135,000
5	2,750,000	137,500

(iv) If in any of the five taxable years the equivalent royalty amount is determined not to be an arm's length amount, a periodic adjustment may be made pursuant to § 1.482–4(f)(2)(i). The adjustment in such case would be equal to the difference between the equivalent royalty amount and the arm's length royalty in that taxable year.

[T.D. 8552, 59 FR 35016, July 8, 1994]

§ 1.482–5 Comparable profits method.

(a) *In general.* 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.

(b) *Determination of arm's length result*—(1) *In general.* Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit for the benefit of FP, and no allocation is made with respect to such activities.

(4) *Consideration not artificially limited.* The arm's length consideration for the controlled transfer of an intangible is not limited by the consideration paid in any uncontrolled transactions that do not meet the requirements of the comparable uncontrolled transaction method described in paragraph (c) of this section. Similarly, the arm's length consideration for an intangible is not limited by the prevailing rates of consideration paid for the use or transfer of intangibles within the same or similar industry.

(5) *Lump sum payments*—(i) *In general.* If an intangible is transferred in a controlled transaction for a lump sum, that amount must be commensurate with the income attributable to the intangible. A lump sum is commensurate with income in a taxable year if the equivalent royalty amount for that taxable year is equal to an arm's length royalty. The equivalent royalty amount for a taxable year is the amount determined by treating the lump sum as an advance payment of a stream of royalties over the useful life of the intangible (or the period covered by an agreement, if shorter), taking into account the projected sales of the licensee as of the date of the transfer. Thus, determining the equivalent royalty amount requires a present value calculation based on the lump sum, an appropriate discount rate, and the projected sales over the relevant period. The equivalent royalty amount is subject to periodic adjustments under § 1.482–4(f)(2)(i) to the same extent as an actual royalty payment pursuant to a license agreement.

(ii) *Exceptions.* No periodic adjustment will be made under paragraph (f)(2)(i) of this section if any of the exceptions to periodic adjustments provided in paragraph (f)(2)(ii) of this section apply.

(iii) *Example.* The following example illustrates the principle of this paragraph (f)(5).

Example. Calculation of the equivalent royalty amount. (i) FSub is the foreign subsidiary of USP, a U.S. company. USP licenses FSub the right to produce and sell the whopperchopper, a patented new kitchen appliance, for the foreign market. The license is for a period of five years, and payment takes the form of a single lump-sum charge of $500,000 that is paid at the beginning of the period.

(ii) The equivalent royalty amount for this license is determined by deriving an equivalent royalty rate equal to the lump-sum payment divided by the present discounted value of FSub's projected sales of whopperchoppers over the life of the license. Based on the riskiness of the whopperchopper business, an appropriate discount rate is determined to be 10 percent. Projected sales of whopperchoppers for each year of the license are as follows:

Year	Projected sales
1	$2,500,000
2	2,600,000
3	2,700,000
4	2,700,000
5	2,750,000

(iii) Based on this information, the present discounted value of the projected whopperchopper sales is approximately $10 million, yielding an equivalent royalty rate of approximately 5%. Thus, the equivalent royalty amounts for each year are as follows:

Year	Projected sales	Equivalent royalty amount
1	$2,500,000	$125,000
2	2,600,000	130,000
3	2,700,000	135,000
4	2,700,000	135,000
5	2,750,000	137,500

(iv) If in any of the five taxable years the equivalent royalty amount is determined not to be an arm's length amount, a periodic adjustment may be made pursuant to § 1.482–4(f)(2)(i). The adjustment in such case would be equal to the difference between the equivalent royalty amount and the arm's length royalty in that taxable year.

[T.D. 8552, 59 FR 35016, July 8, 1994]

§ 1.482–5 Comparable profits method.

(a) *In general.* 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.

(b) *Determination of arm's length result*—(1) *In general.* Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit). Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity). To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions. The tested party's reported operating profit is compared to the comparable operating profits derived from the profit level indicators of uncontrolled comparables to determine whether the reported operating profit represents an arm's length result.

(2) *Tested party*—(i) *In general.* For purposes of this section, the 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. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

(ii) *Adjustments for tested party.* The tested party's operating profit must first be adjusted to reflect all other allocations under section 482, other than adjustments pursuant to this section.

(3) *Arm's length range.* See §1.482–1(e)(2) for the determination of the arm's length range. For purposes of the comparable profits method, the arm's length range will be established using comparable operating profits derived from a single profit level indicator.

(4) *Profit level indicators.* Profit level indicators are ratios that measure relationships between profits and costs incurred or resources employed. A variety of profit level indicators can be calculated in any given case. Whether use of a particular profit level indicator is appropriate depends upon a number of factors, including the nature of the activities of the tested party, the reliability of the available data with respect to uncontrolled comparables, and the extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length, taking into account all of the facts and circumstances. The profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years. This analysis must be applied in accordance with §1.482–1(f)(2)(iii)(D). Profit level indicators that may provide a reliable basis for comparing operating profits of the tested party and uncontrolled comparables include the following—

(i) *Rate of return on capital employed.* The rate of return on capital employed is the ratio of operating profit to operating assets. The reliability of this profit level indicator increases as operating assets play a greater role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this profit level indicator depends on the extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable. Finally, difficulties in properly valuing operating assets will diminish the reliability of this profit level indicator.

(ii) *Financial ratios.* Financial ratios measure relationships between profit and costs or sales revenue. Since functional differences generally have a greater effect on the relationship between profit and costs or sales revenue than the relationship between profit and operating assets, financial ratios are more sensitive to functional differences than the rate of return on capital employed. Therefore, closer functional comparability normally is required under a financial ratio than under the rate of return on capital employed to achieve a similarly reliable measure of an arm's length result. Financial ratios that may be appropriate include the following—

(A) Ratio of operating profit to sales; and

(B) Ratio of gross profit to operating expenses. Reliability under this profit level indicator also depends on the extent to which the composition of the tested party's operating expenses is similar to that of the uncontrolled comparables.

(iii) *Other profit level indicators.* Other profit level indicators not described in this paragraph (b)(4) may be used if they provide reliable measures of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length. However, profit level indicators based solely on internal data may not be used under this paragraph (b)(4) because they are not objective measures of profitability derived from operations of uncontrolled taxpayers engaged in similar business activities under similar circumstances.

(c) *Comparability and reliability considerations*—(1) *In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482–1(c).

(2) *Comparability*—(i) *In general.* The degree of comparability between an uncontrolled taxpayer and the tested party is determined by applying the provisions of §1.482–1(d)(2). The comparable profits method compares the profitability of the tested party, measured by a profit level indicator (generally based on operating profit), to the profitability of uncontrolled taxpayers in similar circumstances. As with all methods that rely on external market benchmarks, the greater the degree of comparability between the tested party and the uncontrolled taxpayer, the more reliable will be the results derived from the application of this method. The determination of the degree of comparability between the tested party and the uncontrolled taxpayer depends upon all the relevant facts and circumstances, including the relevant lines of business, the product or service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital), the size and scope of operations, and the stage in a business or product cycle.

(ii) *Functional, risk and resource comparability.* An operating profit represents a return for the investment of resources and assumption of risks. Therefore, although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on resources employed and risks assumed. Moreover, because resources and risks usually are directly related to functions performed, it is also important to consider functions performed in determining the degree of comparability between the tested party and an uncontrolled taxpayer. The degree of functional comparability required to obtain a reliable result under the comparable profits method, however, is generally less than that required under the resale price or cost plus methods. For example, because differences in functions performed often are reflected in operating expenses, taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit.

(iii) *Other comparability factors.* Other factors listed in §1.482–1(d)(3) also may be particularly relevant under the comparable profits method. Because operating profit usually is less sensitive than gross profit to product differences, reliability under the comparable profits method is not as dependent on product similarity as the resale price or cost plus method. However, the reliability of profitability measures based on operating profit may be adversely affected by factors that have less effect on results under the comparable uncontrolled price, resale price, and cost plus methods. For example, operating profit may be affected by varying cost structures (as reflected, for example, in the age of plant and equipment), differences in business experience (such as whether the business is in a start-up phase or is mature), or differences in management efficiency (as indicated, for example, by objective evidence such as expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(iv) *Adjustments for the differences between the tested party and the uncontrolled taxpayers.* If there are differences between the tested party and an uncontrolled comparable that would materially affect the profits determined under the relevant profit level indicator, adjustments should be made according to the comparability provisions of §1.482–1(d)(2). In some cases, the assets of an uncontrolled comparable may need to be adjusted to achieve greater comparability between the tested party and the uncontrolled comparable. In such cases, the uncontrolled comparable's operating income attributable to those assets must also be adjusted before computing a profit level indicator in order to reflect the income and expense attributable to the adjusted assets. In certain cases it may also be appropriate to adjust the operating profit of the tested party and comparable parties. For example, where there are material differences in accounts payable among the comparable parties and the tested party, it will generally be appropriate to adjust the operating profit of each party by increasing it to reflect an imputed interest charge on each party's accounts payable. As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by §1.482–7(d)(2)(i)) among the tested party and comparable parties.

(3) *Data and assumptions*—(i) *In general.* The reliability of the results derived from the comparable profits method is affected by the quality of the data and assumptions used to apply this method.

(ii) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results.

(iii) *Allocations between the relevant business activity and other activities.* The reliability of the allocation of costs, income, and assets between the relevant business activity and other activities of the tested party or an uncontrolled comparable will affect the reliability of the determination of operating profit and profit level indicators. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the profit level indicator to the tested party's financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the profit level indicator solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced.

(d) *Definitions.* The definitions set forth in paragraphs (d)(1) through (6) of this section apply for purposes of this section.

(1) *Sales revenue* means the amount of the total receipts from sale of goods and provision of services, less returns and allowances. Accounting principles and conventions that are generally accepted in the trade or industry of the controlled taxpayer under review must be used.

(2) *Gross profit* means sales revenue less cost of goods sold.

(3) *Operating expenses* includes all expenses not included in cost of goods sold except for interest expense, foreign income taxes (as defined in §1.901–2(a)), domestic income taxes, and any other expenses not related to the operation of the relevant business activity.

Operating expenses ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing and distribution, administration, and a reasonable allowance for depreciation and amortization.

(4) *Operating profit* means gross profit less operating expenses. Operating profit includes all income derived from the business activity being evaluated by the comparable profits method, but does not include interest and dividends, income derived from activities not being tested by this method, or extraordinary gains and losses that do not relate to the continuing operations of the tested party.

(5) *Reported operating profit* means the operating profit of the tested party reflected on a timely filed U.S. income tax return. If the tested party files a U.S. income tax return, its operating profit is considered reflected on a U.S. income tax return if the calculation of taxable income on its return for the taxable year takes into account the income attributable to the controlled transaction under review. If the tested party does not file a U.S. income tax return, its operating profit is considered reflected on a U.S. income tax return in any taxable year for which income attributable to the controlled transaction under review affects the calculation of the U.S. taxable income of any other member of the same controlled group. If the comparable operating profit of the tested party is determined from profit level indicators derived from financial statements or other accounting records and reports of comparable parties, adjustments may be made to the reported operating profit of the tested party in order to account for material differences between the tested party's operating profit reported for U.S income tax purposes and the tested party's operating profit for financial statement purposes. In addition, in accordance with §1.482–1(f)(2)(iii)(D), adjustments under section 482 that are finally determined may be taken into account in determining reported operating profit.

(6) *Operating assets*. The term operating assets means the value of all assets used in the relevant business activity of the tested party, including fixed assets and current assets (such as cash, cash equivalents, accounts receivable, and inventories).

The term does not include investments in subsidiaries, excess cash, and portfolio investments. Operating assets may be measured by their net book value or by their fair market value, provided that the same method is consistently applied to the tested party and the comparable parties, and consistently applied from year to year. In addition, it may be necessary to take into account recent acquisitions, leased assets, intangibles, currency fluctuations, and other items that may not be explicitly recorded in the financial statements of the tested party or uncontrolled comparable. Finally, operating assets must be measured by the average of the values for the beginning of the year and the end of the year, unless substantial fluctuations in the value of operating assets during the year make this an inaccurate measure of the average value over the year. In such a case, a more accurate measure of the average value of operating assets must be applied.

(e) *Examples*. The following examples illustrate the application of this section.

Example 1. Transfer of tangible property resulting in no adjustment. (i) FP is a publicly traded foreign corporation with a U.S. subsidiary, USSub, that is under audit for its 1996 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.

(ii) FP does not allow uncontrolled taxpayers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled taxpayers or to uncontrolled distributors.

(iii) Based on all the facts and circumstances, the district director determines that the comparable profits method will provide the most reliable measure of an arm's length result. USSub is selected as the tested party because it engages in activities that are less complex than those undertaken by FP.

There is data from a number of independent operators of wholesale distribution businesses. These potential comparables 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 shows 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 1994 through 1996, USSub shows the following results:

	1994	1995	1996	Average
Sales	$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

(iv) 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 uncontrolled distributors. Applying each ratio to USSub would lead to the following comparable operating profit (COP) for USSub:

Uncontrolled distributor	OP/S (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

(v) The data is 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 be established only pursuant to §1.482-1(e)(2)(iii)(B). The district director measures the arm's length range by the interquartile range of results, which consists of the results ranging from $19,760 to $34,840. Although USSub's operating income for 1996 shows a loss of $4,600, the district director determines that no allocation should be made, because USSub's average reported operating profit of $20,000 is within this range.

Example 2. Transfer of tangible property resulting in adjustment. (i) The facts are the same as in *Example 1* except that USSub reported the following income and expenses:

	1994	1995	1996	Average
Sales	$500,000	$560,000	$500,000	$520,000
Cost of Good 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

(ii) The interquartile range of comparable operating profits remains the same as derived in *Example 1:* $19,760 to $34,840. USSub's average operating profit for the years 1994 through 1996 ($0) falls outside this range. Therefore, the district director determines that an allocation may be appropriate.

(iii) To determine the amount, if any, of the allocation, the district director compares USSub's reported operating profit for 1996 to comparable operating profits derived from the uncontrolled distributors' results for 1996. The ratio of operating profit to sales in 1996 is calculated for each of the uncontrolled comparables and applied to USSub's 1996 sales to derive the following results:

Uncontrolled distributor	OP/S (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

(iv) Based on these results, the median of the comparable operating profits for 1996 is $14,250. Therefore, USSub's income for 1996 is increased by $24,250, the difference between USSub's reported operating profit for 1996 and the median of the comparable operating profits for 1996.

Example 3. Multiple year analysis. (i) The facts are the same as in *Example 2.* In addition, the district director examines the taxpayer's results for the 1997 taxable year. As in *Example 2*, the district director increases USSub's income for the 1996 taxable year by $24,250. The results for the 1997 taxable year, together with the 1995 and 1996 taxable years, are as follows:

	1995	1996	1997	Average
Sales	$560,000	$500,000	$530,000	$530,000
Cost of Good 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)

(ii) The interquartile range of comparable operating profits, based on average results from the uncontrolled comparables and average sales for USSub for the years 1995 through 1997, ranges from $15,500 to $30,000. In determining whether an allocation for the 1997 taxable year may be made, the district director compares USSub's average reported operating profit for the years 1995 through 1997 to the interquartile range of average comparable operating profits over this period. USSub's average reported operating profit is determined without regard to the adjustment made with respect to the 1996 taxable year. See §1.482–1(f)(2)(iii)(D). Therefore, USSub's average reported operating profit for the years 1995 through 1997 is ($10,000). Because this amount of income falls outside the interquartile range, the district director determines that an allocation may be appropriate.

(iii) To determine the amount, if any, of the allocation for the 1997 taxable year, the district director compares USSub's reported operating profit for 1997 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1997. The median of the comparable operating profits derived from the uncontrolled comparables results for the 1997 taxable year is $12,000. Based on this comparison, the district director increases USSub's 1997 taxable income by $22,000, the difference between the median of the comparable operating profits for the 1997 taxable year and USSub's reported operating profit of ($10,000) for the 1997 taxable year.

Example 4. Transfer of intangible to offshore manufacturer. (i) 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 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 taxable year 1996 is under audit, and the district director examines whether the royalty rate of 5 percent paid by ManuCo to DevCo is an arm's length consideration for the htw technology.

(ii) Based on all the facts and circumstances, the district director determines that the comparable profits method will provide the most reliable measure of an arm's length result. ManuCo is selected as the tested party because it engages in relatively routine manufacturing activities, while DevCo engages in a variety of complex activities using unique and valuable intangibles. 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.

(iii) Uncontrolled taxpayers performing similar functions cannot be found in country H. It is determined that data available in countries M and N provides the best match of companies in a similar market performing similar functions and bearing similar risks. Such data is sufficiently complete to identify many of the material differences between ManuCo and the uncontrolled comparables, and to make adjustments to account for such differences. However, data is not sufficiently complete so that it is likely that no material differences remain. In particular, the differences in geographic markets might have materially affected the results of the various companies.

(iv) In a separate analysis, it is determined that the price that ManuCo charged to MarkCo for the htw's is an arm's length price under §1.482–3(b). Therefore, ManuCo's financial data derived from its sales to MarkCo are reliable. ManuCo's financial data from 1994–1996 is as follows:

	1994	1995	1996	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
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

(v) Applying the ratios of average operating profit to operating assets for the 1994 through 1996 taxable years derived from a group of similar uncontrolled comparables located in country M and N to ManuCo's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is $3,000 to $4,500. ManuCo's average reported operating profit for the years 1994 through 1996 ($21,500) falls outside this range. Therefore, the district director determines that an allocation may be appropriate for the 1996 taxable year.

(vi) To determine the amount, if any, of the allocation for the 1996 taxable year, the district director compares ManuCo's reported operating profit for 1996 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1996. The median result for the uncontrolled comparables for 1996 is $3,750. Based on this comparison, the district director increases royalties that ManuCo paid by $21,500 (the difference between $25,250 and the median of the comparable operating profits, $3,750).

Example 5. Adjusting operating assets and operating profit for differences in accounts receivable. (i) USM is a U.S. company that manufactures parts for industrial equipment and sells them to its foreign parent corporation. For purposes of applying the comparable profits method, 15 uncontrolled manufacturers that are similar to USM have been identified.

(ii) USM has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is to be used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed USM's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying the uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-term debt.

Example 6. Adjusting operating profit for differences in accounts payable. (i) 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 uncontrolled distributors that are similar to USD have been identified.

(ii) There are significant differences in the level of accounts payable among the uncontrolled distributors and USD. To adjust for these differences, the district director increases the operating profit of the uncontrolled distributors and USD to reflect interest expense imputed to the accounts payable. The imputed interest expense for each company is calculated by multiplying the company's accounts payable by an interest rate appropriate for its short-term debt.

[T.D. 8552, 59 FR 35021, July 8, 1994; 60 FR 16703, Mar. 31, 1995; T.D. 9088, 68 FR 51177, Aug. 26, 2003]

§ 1.482–6 Profit split method.

(a) *In general.* The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

(b) *Appropriate share of profits and losses.* The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions of § 1.482–1(d)(3). 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 group may earn a profit while another member incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The specific method of allocation must be determined under paragraph (c) of this section.

(c) *Application*—(1) *In general.* The allocation of profit or loss under the

(v) Applying the ratios of average operating profit to operating assets for the 1994 through 1996 taxable years derived from a group of similar uncontrolled comparables located in country M and N to ManuCo's average operating assets for the same period provides a set of comparable operating profits. The interquartile range for these average comparable operating profits is $3,000 to $4,500. ManuCo's average reported operating profit for the years 1994 through 1996 ($21,500) falls outside this range. Therefore, the district director determines that an allocation may be appropriate for the 1996 taxable year.

(vi) To determine the amount, if any, of the allocation for the 1996 taxable year, the district director compares ManuCo's reported operating profit for 1996 to the median of the comparable operating profits derived from the uncontrolled distributors' results for 1996. The median result for the uncontrolled comparables for 1996 is $3,750. Based on this comparison, the district director increases royalties that ManuCo paid by $21,500 (the difference between $25,250 and the median of the comparable operating profits, $3,750).

Example 5. Adjusting operating assets and operating profit for differences in accounts receivable. (i) USM is a U.S. company that manufactures parts for industrial equipment and sells them to its foreign parent corporation. For purposes of applying the comparable profits method, 15 uncontrolled manufacturers that are similar to USM have been identified.

(ii) USM has a significantly lower level of accounts receivable than the uncontrolled manufacturers. Since the rate of return on capital employed is to be used as the profit level indicator, both operating assets and operating profits must be adjusted to account for this difference. Each uncontrolled comparable's operating assets is reduced by the amount (relative to sales) by which they exceed USM's accounts receivable. Each uncontrolled comparable's operating profit is adjusted by deducting imputed interest income on the excess accounts receivable. This imputed interest income is calculated by multiplying the uncontrolled comparable's excess accounts receivable by an interest rate appropriate for short-term debt.

Example 6. Adjusting operating profit for differences in accounts payable. (i) 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 uncontrolled distributors that are similar to USD have been identified.

(ii) There are significant differences in the level of accounts payable among the uncontrolled distributors and USD. To adjust for these differences, the district director increases the operating profit of the uncontrolled distributors and USD to reflect interest expense imputed to the accounts payable. The imputed interest expense for each company is calculated by multiplying the company's accounts payable by an interest rate appropriate for its short-term debt.

[T.D. 8552, 59 FR 35021, July 8, 1994; 60 FR 16703, Mar. 31, 1995; T.D. 9088, 68 FR 51177, Aug. 26, 2003]

§ 1.482–6 Profit split method.

(a) *In general.* The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

(b) *Appropriate share of profits and losses.* The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the comparability provisions of § 1.482–1(d)(3). 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 group may earn a profit while another member incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The specific method of allocation must be determined under paragraph (c) of this section.

(c) *Application*—(1) *In general.* The allocation of profit or loss under the profit split method must be made in accordance with one of the following allocation methods—(i) The comparable profit split, described in paragraph (c)(2) of this section; or

(ii) The residual profit split, described in paragraph (c)(3) of this section.

(2) *Comparable profit split*—(i) *In general.* A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.

(ii) *Comparability and reliability considerations—(A) In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in §1.482–1(c).

(B) *Comparability*—(*1*) *In general.* The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability provisions of §1.482–1(d). The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. Although all of the factors described in §1.482–1(d)(3) must be considered, comparability under this method is particularly dependent on the considerations described under the comparable profits method in §1.482–5(c)(2), because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

(*2*) *Adjustments for differences between the controlled and uncontrolled taxpayers.* If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of §1.482–1(d)(2).

(C) *Data and assumptions.* The reliability of the results derived from the comparable profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(*1*) The reliability of the allocation of costs, income, and assets between the relevant business activity and the participants' other activities will affect the accuracy of the determination of combined operating profit and its allocation among the participants. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the application of this method is affected by the extent to which it is possible to apply the method to the parties' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced.

(*2*) The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, accounting consistency among the participants in the controlled transaction is required to ensure that the items determining the amount and allocation of operating profit are measured on a consistent basis.

(D) *Other factors affecting reliability.* Like the methods described in §§ 1.482–3, 1.482–4, and 1.482–5, the comparable profit split relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(3) *Residual profit split*—(i) *In general.* Under this method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set forth in paragraphs (c)(3)(i)(A) and (B) of this section.

(A) *Allocate income to routine contributions.* The first step allocates operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§ 1.482–3, 1.482–4 and 1.482–5.

(B) *Allocate residual profit.* The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this section. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution. The relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of intangible contributions may be estimated by the capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property of all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of intangible contributions. If the intangible property contributed by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the intangibles must be made among all the business activities in which it is used.

(ii) *Comparability and reliability considerations*—(A) *In general.* Whether results derived from this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule in § 1.482–1(c). Thus, comparability and the quality of data and assumptions must be considered in determining whether this method provides the most reliable measure of an arm's length result. The application of these factors to the residual profit split is discussed in paragraph (c)(3)(ii)(B), (C), and (D) of this section.

(B) *Comparability*. The first step of the residual profit split relies on market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for the routine contributions. The second step of the residual profit split, however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks.

(C) *Data and assumptions.* The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered—

(*1*) The reliability of the allocation of costs, income, and assets as described in paragraph (c)(2)(ii)(C)(*1*) of this section;

(*2*) Accounting consistency as described in paragraph (c)(2)(ii)(C)(*2*) of this section;

(*3*) The reliability of the data used and the assumptions made in valuing the intangible property contributed by the participants. In particular, if capitalized costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. First, in any given case, the costs of developing the intangible may not be related to its market value. Second, the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may affect the reliability of the analysis. Finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

(D) *Other factors affecting reliability*. Like the methods described in §§ 1.482–3, 1.482–4, and 1.482–5, the first step of the residual profit split relies exclusively on external market benchmarks. As indicated in § 1.482–1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the second step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(iii) *Example.* The provisions of this paragraph (c)(3) are illustrated by the following example.

Example—Application of Residual Profit Split. (i) XYZ is a U.S. corporation that develops, manufactures and markets a line of products for police use in the United States. XYZ's research unit developed a bulletproof material for use in protective clothing and headgear (Nulon). XYZ obtains patent protection for the chemical formula for Nulon. Since its introduction in the U.S., Nulon has captured a substantial share of the U.S. market for bulletproof material.

(ii) XYZ licensed its European subsidiary, XYZ-Europe, to manufacture and market Nulon in Europe. XYZ-Europe is a well- established company that manufactures and markets XYZ products in Europe. XYZ-Europe has a research unit that adapts XYZ products for the defense market, as well as a well-developed marketing network that employs brand names that it developed.

(iii) XYZ-Europe's research unit alters Nulon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defense industry in several European countries. Beginning with the 1995 taxable year, XYZ-Europe manufactures and sells Nulon in Europe through its marketing network under one of its brand names.

(iv) For the 1995 taxable year, XYZ has no direct expenses associated with the license of Nulon to XYZ-Europe and incurs no expenses related to the marketing of Nulon in Europe. For the 1995 taxable year, XYZ-Europe's Nulon sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Nulon business. The operating assets employed in XYZ-Europe's Nulon business are $200 million. Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of European companies performing functions similar to those of XYZ-Europe, the district director determines that an average market return on XYZ-Europe's operating assets in the Nulon business is 10 percent, resulting in a market return of $20 million (10% X $200 million) for XYZ- Europe's Nulon business, and a residual profit of $180 million.

(v) Since the first stage of the residual profit split allocated profits to XYZ-Europe's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 million is attributable to the valuable intangibles related to Nulon, i.e., the European brand name for Nulon and the Nulon formula (including XYZ-Europe's modifications). To estimate the relative values of these intangibles, the district director compares the ratios of the capitalized value of expenditures as of 1995 on Nulon-related research and development and marketing over the 1995 sales related to such expenditures.

(vi) Because XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The district director determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the district director capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in 1995.

(vii) XYZ-Europe's expenditures on Nulon research and development and marketing support only its sales in Europe. Using information on the average useful life of XYZ-Europe's investments in marketing and research and development, the district director capitalizes and amortizes XYZ-Europe's expenditures and determines that they have a value in 1995 of $0.40 per dollar of XYZ-Europe's Nulon sales.

(viii) Thus, XYZ and XYZ-Europe together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Europe's protective product sales for 1995, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the district director determines that an arm's length royalty for the Nulon license for the 1995 taxable year is $60 million, i.e., one-third of XYZ-Europe's $180 million in residual Nulon profit.

[T.D. 8552, 59 FR 35025, July 8, 1994; 60 FR 16382, Mar. 30, 1995]

§ 1.482–7 Sharing of costs.

(a) *In general*—(1) *Scope and application of the rules in this section.* A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section. Consistent with the rules of § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms), the district director may apply the rules of this section to any arrangement that in substance constitutes a cost sharing arrangement, notwithstanding a failure to comply with any requirement of this section. A qualified cost sharing arrangement, or an arrangement to which the district director applies the rules of this section, will not be treated the chemical formula for Nulon. Since its introduction in the U.S., Nulon has captured a substantial share of the U.S. market for bulletproof material.

(ii) XYZ licensed its European subsidiary, XYZ-Europe, to manufacture and market Nulon in Europe. XYZ-Europe is a well- established company that manufactures and markets XYZ products in Europe. XYZ-Europe has a research unit that adapts XYZ products for the defense market, as well as a well-developed marketing network that employs brand names that it developed.

(iii) XYZ-Europe's research unit alters Nulon to adapt it to military specifications and develops a high-intensity marketing campaign directed at the defense industry in several European countries. Beginning with the 1995 taxable year, XYZ-Europe manufactures and sells Nulon in Europe through its marketing network under one of its brand names.

(iv) For the 1995 taxable year, XYZ has no direct expenses associated with the license of Nulon to XYZ-Europe and incurs no expenses related to the marketing of Nulon in Europe. For the 1995 taxable year, XYZ-Europe's Nulon sales and pre-royalty expenses are $500 million and $300 million, respectively, resulting in net pre-royalty profit of $200 million related to the Nulon business. The operating assets employed in XYZ-Europe's Nulon business are $200 million. Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's length result. Based on an examination of a sample of European companies performing functions similar to those of XYZ-Europe, the district director determines that an average market return on XYZ-Europe's operating assets in the Nulon business is 10 percent, resulting in a market return of $20 million (10% X $200 million) for XYZ- Europe's Nulon business, and a residual profit of $180 million.

(v) Since the first stage of the residual profit split allocated profits to XYZ-Europe's contributions other than those attributable to highly valuable intangible property, it is assumed that the residual profit of $180 million is attributable to the valuable intangibles related to Nulon, i.e., the European brand name for Nulon and the Nulon formula (including XYZ-Europe's modifications). To estimate the relative values of these intangibles, the district director compares the ratios of the capitalized value of expenditures as of 1995 on Nulon-related research and development and marketing over the 1995 sales related to such expenditures.

(vi) Because XYZ's protective product research and development expenses support the worldwide protective product sales of the XYZ group, it is necessary to allocate such expenses among the worldwide business activities to which they relate. The district director determines that it is reasonable to allocate the value of these expenses based on worldwide protective product sales. Using information on the average useful life of its investments in protective product research and development, the district director capitalizes and amortizes XYZ's protective product research and development expenses. This analysis indicates that the capitalized research and development expenditures have a value of $0.20 per dollar of global protective product sales in 1995.

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(viii) Thus, XYZ and XYZ-Europe together contributed $0.60 in capitalized intangible development expenses for each dollar of XYZ-Europe's protective product sales for 1995, of which XYZ contributed one-third (or $0.20 per dollar of sales). Accordingly, the district director determines that an arm's length royalty for the Nulon license for the 1995 taxable year is $60 million, i.e., one-third of XYZ-Europe's $180 million in residual Nulon profit.

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(2) *Limitation on allocations.* The district director shall not make allocations with respect to a qualified cost sharing arrangement except to the extent necessary to make each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equal to its share of reasonably anticipated benefits attributable to such development, under the rules of this section. If a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the district director may make appropriate allocations to reflect an arm's length consideration for the acquisition of the interest in such intangible under the rules of §§ 1.482–1 and 1.482–4 through 1.482–6. See paragraph (g) of this section. An interest in an intangible includes any commercially transferable interest, the benefits of which are susceptible of valuation. See § 1.482–4(b) for the definition of an intangible.

(3) *Coordination with § 1.482–1.* A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482–1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

(4) *Cross references.* Paragraph (c) of this section defines participant. Paragraph (d) of this section defines the costs of intangible development. Paragraph (e) of this section defines the anticipated benefits of intangible development. Paragraph (f) of this section provides rules governing cost allocations. Paragraph (g) of this section provides rules governing transfers of intangibles other than in consideration for bearing a share of the costs of the intangible's development. Rules governing the character of payments made pursuant to a qualified cost sharing arrangement are provided in paragraph (h) of this section. Paragraph (i) of this section provides accounting requirements. Paragraph (j) of this section provides administrative requirements. Paragraph (k) of this section provides an effective date. Paragraph (l) provides a transition rule.

(b) *Qualified cost sharing arrangement.* A qualified cost sharing arrangement must—

(1) Include two or more participants;

(2) Provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;

(3) Provide for adjustment to the controlled participants' shares of intangible development costs to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement; and

(4) Be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement and that includes—

(i) A list of the arrangement's participants, and any other member of the controlled group that will benefit from the use of intangibles developed under the cost sharing arrangement;

(ii) The information described in paragraphs (b)(2) and (b)(3) of this section;

(iii) A description of the scope of the research and development to be undertaken, including the intangible or class of intangibles intended to be developed;

(iv) A description of each participant's interest in any covered intangibles. A covered intangible is any intangible property that is developed as a result of the research and development undertaken under the cost sharing arrangement (intangible development area);

(v) The duration of the arrangement; and

(vi) The conditions under which the arrangement may be modified or terminated and the consequences of such modification or termination, such as the interest that each participant will receive in any covered intangibles.

(c) *Participant*—(1) *In general.* For purposes of this section, a participant is a controlled taxpayer that meets the requirements of this paragraph (c)(1) (controlled participant) or an uncontrolled taxpayer that is a party to the cost sharing arrangement (uncontrolled participant). See §1.482–1(i)(5) for the definitions of controlled and uncontrolled taxpayers. A controlled taxpayer may be a controlled participant only if it—

(i) Reasonably anticipates that it will derive benefits from the use of covered intangibles;

(ii) Substantially complies with the accounting requirements described in paragraph (i) of this section; and

(iii) Substantially complies with the administrative requirements described in paragraph (j) of this section.

(iv) The following example illustrates paragraph (c)(1)(i) of this section:

Example. Foreign Parent (FP) is a foreign corporation engaged in the extraction of a natural resource. FP has a U.S. subsidiary (USS) to which FP sells supplies of this resource for sale in the United States. FP enters into a cost sharing arrangement with USS to develop a new machine to extract the natural resource. The machine uses a new extraction process that will be patented in the United States and in other countries. The cost sharing arrangement provides that USS will receive the rights to use the machine in the extraction of the natural resource in the United States, and FP will receive the rights in the rest of the world. This resource does not, however, exist in the United States. Despite the fact that USS has received the right to use this process in the United States, USS is not a qualified participant because it will not derive a benefit from the use of the intangible developed under the cost sharing arrangement.

(2) *Treatment of a controlled taxpayer that is not a controlled participant*—(i) *In general.* If a controlled taxpayer that is not a controlled participant (within the meaning of this paragraph (c)) provides assistance in relation to the research and development undertaken in the intangible development area, it must receive consideration from the controlled participants under the rules of §1.482–4(f)(3)(iii) (Allocations with respect to assistance provided to the owner). For purposes of paragraph (d) of this section, such consideration is treated as an operating expense and each controlled participant must be treated as incurring a share of such consideration equal to its share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section).

(ii) *Example.* The following example illustrates this paragraph (c)(2):

Example. (i) U.S. Parent (USP), one foreign subsidiary (FS), and a second foreign subsidiary constituting the group's research arm (R+D) enter into a cost sharing agreement to develop manufacturing intangibles for a new product line A. USP and FS are assigned the exclusive rights to exploit the intangibles respectively in the United States and the rest of the world, where each presently manufactures and sells various existing product lines. R+D is not assigned any rights to exploit the intangibles. R+D's activity consists solely in carrying out research for the group. It is reliably projected that the shares of reasonably anticipated benefits of USP and FS will be 66⅔% and 33⅓, respectively, and the parties' agreement provides that USP and FS will reimburse 66⅔% and 33⅓%, respectively, of the intangible development costs incurred by R+D with respect to the new intangible.

(ii) R+D does not qualify as a controlled participant within the meaning of paragraph (c) of this section, because it will not derive any benefits from the use of covered intangibles. Therefore, R+D is treated as a service provider for purposes of this section and must receive arm's length consideration for the assistance it is deemed to provide to USP and FS, under the rules of §1.482–4(f)(3)(iii). Such consideration must be treated as intangible development costs incurred by USP and FS in proportion to their shares of reasonably anticipated benefits (i.e., 66⅔% and 33⅓%, respectively). R+D will not be considered to bear any share of the intangible development costs under the arrangement.

(3) *Treatment of consolidated group.* For purposes of this section, all members of the same affiliated group (within the meaning of section 1504(a)) that join in the filing of a consolidated return for the taxable year under section 1501 shall be treated as one taxpayer.

(d) *Costs*—(1) *Intangible development costs.* For purposes of this section, a controlled participant's costs of developing intangibles for a taxable year mean all of the costs incurred by that participant related to the intangible development area, plus all of the cost sharing payments it makes to other controlled and uncontrolled participants, minus all of the cost sharing payments it receives from other controlled and uncontrolled participants. Costs incurred related to the intangible development area consist of the following items: operating expenses as defined in § 1.482–5(d)(3), other than depreciation or amortization expense, plus (to the extent not included in such operating expenses, as defined in § 1.482–5(d)(3)) the charge for the use of any tangible property made available to the qualified cost sharing arrangement. If tangible property is made available to the qualified cost sharing arrangement by a controlled participant, the determination of the appropriate charge will be governed by the rules of § 1.482–2(c) (Use of tangible property). Intangible development costs do not include the consideration for the use of any intangible property made available to the qualified cost sharing arrangement. See paragraph (g)(2) of this section. If a particular cost contributes to the intangible development area and other areas or other business activities, the cost must be allocated between the intangible development area and the other areas or business activities on a reasonable basis. In such a case, it is necessary to estimate the total benefits attributable to the cost incurred. The share of such cost allocated to the intangible development area must correspond to covered intangibles' share of the total benefits. Costs that do not contribute to the intangible development area are not taken into account.

(2) *Stock-based compensation*—(i) *In general.* For purposes of this section, a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development.* The determination of whether stock-based compensation is related to the intangible development area within the meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense*—(A) *In general.* Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for Federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(*1*) *Transfers to which section 421 applies.* Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(*2*) *Deductions of foreign controlled participants.* Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as an allowable deduction of a controlled participant to the extent that a deduction would be allowable to a United States taxpayer.

(*3*) *Modification of stock option.* Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(*4*) *Expiration or termination of qualified cost sharing arrangement.* Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then exercisable and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock*—(1) *In general.* With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, provided that such statements are prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock.

(*2*) *Publicly traded stock.* As used in this paragraph (d)(2)(iii)(B), the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in accordance with United States generally accepted accounting principles for the taxable year.

(*3*) *Generally accepted accounting principles.* For purposes of this paragraph (d)(2)(iii)(B), a financial statement prepared in accordance with a comprehensive body of generally accepted accounting principles other than United States generally accepted accounting principles is considered to be prepared in accordance with United States generally accepted accounting principles provided that either—

(*i*) The fair value of the stock options under consideration is reflected in the reconciliation between such other accounting principles and United States generally accepted accounting principles required to be incorporated into the financial statement by the securities laws governing companies whose stock is regularly traded on United States securities markets; or

(*ii*) In the absence of a reconciliation between such other accounting principles and United States generally accepted accounting principles that reflects the fair value of the stock options under consideration, such other accounting principles require that the fair value of the stock options under consideration be reflected as a charge against income in audited financial statements or disclosed in footnotes to such statements.

(*4*) *Time and manner of making the election.* The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on August 26, 2003, the election must be made by written amendment to the cost sharing agreement not later than the latest due date (with regard to extensions) of a Federal income tax return of any controlled participant for the first taxable year beginning after August 26, 2003, and the consent of the Commissioner is not required.

(C) *Consistency*. Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(*4*) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

(3) *Examples.* The following examples illustrate this paragraph (d):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a qualified cost sharing arrangement to develop a better mousetrap. USS and FP share the costs of FP's research and development facility that will be exclusively dedicated to this research, the salaries of the researchers, and reasonable overhead costs attributable to the project. They also share the cost of a conference facility that is at the disposal of the senior executive management of each company but does not contribute to the research and development activities in any measurable way. In this case, the cost of the conference facility must be excluded from the amount of intangible development costs.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a qualified cost sharing arrangement to develop a new device. USP and FS share the costs of a research and development facility, the salaries of researchers, and reasonable overhead costs attributable to the project. USP also incurs costs related to field testing of the device, but does not include them in the amount of intangible development costs of the cost sharing arrangement. The district director may determine that the field testing costs are intangible development costs that must be shared.

(e) *Anticipated benefits*—(1) *Benefits.* Benefits are additional income generated or costs saved by the use of covered intangibles.

(2) *Reasonably anticipated benefits.* For purposes of this section, a controlled participant's reasonably anticipated benefits are the aggregate benefits that it reasonably anticipates that it will derive from covered intangibles.

(f) *Cost allocations*—(1) *In general.* For purposes of determining whether a cost allocation authorized by paragraph (a)(2) of this section is appropriate for a taxable year, a controlled participant's share of intangible development costs for the taxable year under a qualified cost sharing arrangement must be compared to its share of reasonably anticipated benefits under the arrangement. A controlled participant's share of intangible development costs is determined under paragraph (f)(2) of this section. A controlled participant's share of reasonably anticipated benefits under the arrangement is determined under paragraph (f)(3) of this section. In determining whether benefits were reasonably anticipated, it may be appropriate to compare actual benefits to anticipated benefits, as described in paragraph (f)(3)(iv) of this section.

(2) *Share of intangible development costs*—(i) *In general.* A controlled participant's share of intangible development costs for a taxable year is equal to its intangible development costs for the taxable year (as defined in paragraph (d) of this section), divided by the sum of the intangible development costs for the taxable year (as defined in paragraph (d) of this section) of all the controlled participants.

(ii) *Example.* The following example illustrates this paragraph (f)(2):

Example (i) U.S. Parent (USP), Foreign Subsidiary (FS), and Unrelated Third Party (UTP) enter into a cost sharing arrangement to develop new audio technology. In the first year of the arrangement, the controlled participants incur $2,250,000 in the intangible development area, all of which is incurred directly by USP. In the first year, UTP makes a $250,000 cost sharing payment to USP, and FS makes a $800,000 cost sharing payment to USP, under the terms of the arrangement. For that year, the intangible development costs borne by USP are $1,200,000 (its $2,250,000 intangible development costs directly incurred, minus the cost sharing payments it receives of $250,000 from UTP and $800,000 from FS); the intangible development costs borne by FS are $800,000 (its cost sharing payment); and the intangible development costs borne by all of the controlled participants are $2,000,000 (the sum of the intangible development costs borne by USP and FS of $1,200,000 and $800,000, respectively). Thus, for the first year, USP's share of intangible development costs is 60% ($1,200,000 divided by $2,000,000), and FS's share of intangible development costs is 40% ($800,000 divided by $2,000,000).

(ii) For purposes of determining whether a cost allocation authorized by paragraph §1.482–7(a)(2) is appropriate for the first year, the district director must compare USP's and FS's shares of intangible development costs for that year to their shares of reasonably anticipated benefits. See paragraph (f)(3) of this section.

(3) *Share of reasonably anticipated benefits*—(i) *In general.* A controlled participant's share of reasonably anticipated benefits under a qualified cost sharing arrangement is equal to its reasonably anticipated benefits (as defined in paragraph (e)(2) of this section), divided by the sum of the reasonably anticipated benefits (as defined in paragraph (e)(2) of this section) of all the controlled participants. The anticipated benefits of an uncontrolled participant will not be included for purposes of determining each controlled participant's share of anticipated benefits. A controlled participant's share of reasonably anticipated benefits will be determined using the most reliable estimate of reasonably anticipated benefits. In determining which of two or more available estimates is most reliable, the quality of the data and assumptions used in the analysis must be taken into account, consistent with §1.482–1(c)(2)(ii) (Data and assumptions). Thus, the reliability of an estimate will depend largely on the completeness and accuracy of the data, the soundness of the assumptions, and the relative effects of particular deficiencies in data or assumptions on different estimates. If two estimates are equally reliable, no adjustment should be made based on differences in the results. The following factors will be particularly relevant in determining the reliability of an estimate of anticipated benefits—

(A) The reliability of the basis used for measuring benefits, as described in paragraph (f)(3)(ii) of this section; and

(B) The reliability of the projections used to estimate benefits, as described in paragraph (f)(3)(iv) of this section.

(ii) *Measure of benefits.* In order to estimate a controlled participant's share of anticipated benefits from covered intangibles, the amount of benefits that each of the controlled participants is reasonably anticipated to derive from covered intangibles must be measured on a basis that is consistent for all such participants. See paragraph (f)(3)(iii)(E), *Example 8*, of this section. If a controlled participant transfers covered intangibles to another controlled taxpayer, such participant's benefits from the transferred intangibles must be measured by reference to the transferee's benefits, disregarding any consideration paid by the transferee to the controlled participant (such as a royalty pursuant to a license agreement). Anticipated benefits are measured either on a direct basis, by reference to estimated additional income to be generated or costs to be saved by the use of covered intangibles, or on an indirect basis, by reference to certain measurements that reasonably can be assumed to be related to income generated or costs saved. Such indirect bases of measurement of anticipated benefits are described in paragraph (f)(3)(iii) of this section. A controlled participant's anticipated benefits must be measured on the most reliable basis, whether direct or indirect. In determining which of two bases of measurement of reasonably anticipated benefits is most reliable, the factors set forth in §1.482–1(c)(2)(ii) (Data and assumptions) must be taken into account. It normally will be expected that the basis that provided the most reliable estimate for a particular year will continue to provide the most reliable estimate in subsequent years, absent a material change in the factors that affect the reliability of the estimate. Regardless of whether a direct or indirect basis of measurement is used, adjustments may be required to account for material differences in the activities that controlled participants undertake to exploit their interests in covered intangibles. See *Example 6* of paragraph (f)(3)(iii)(E) of this section.

(iii) *Indirect bases for measuring anticipated benefits.* Indirect bases for measuring anticipated benefits from participation in a qualified cost sharing arrangement include the following:

(A) *Units used, produced or sold.* Units of items used, produced or sold by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to the covered intangibles per unit of the item or items used, produced or sold. This circumstance is most likely to arise when the covered intangibles are exploited by the controlled participants in the use, production or sale of substantially uniform items under similar economic conditions.

(B) *Sales.* Sales by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to covered intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting covered intangibles are not substantial relative to the revenues generated, or if the principal effect of using covered intangibles is to increase the controlled participants' revenues (e.g., through a price premium on the products they sell) without affecting their costs substantially. Sales by each controlled participant are unlikely to provide a reliable basis for measuring benefits unless each controlled participant operates at the same market level (e.g., manufacturing, distribution, etc.).

(C) *Operating profit.* Operating profit of each controlled participant from the activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that such profit is largely attributable to the use of covered intangibles, or if the share of profits attributable to the use of covered intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when covered intangibles are integral to the activity that generates the profit and the activity could not be carried on or would generate little profit without use of those intangibles.

(D) *Other bases for measuring anticipated benefits.* Other bases for measuring anticipated benefits may, in some circumstances, be appropriate, but only to the extent that there is expected to be a reasonably identifiable relationship between the basis of measurement used and additional income generated or costs saved by the use of covered intangibles. For example, a division of costs based on employee compensation would be considered unreliable unless there were a relationship between the amount of compensation and the expected income of the controlled participants from the use of covered intangibles.

(E) *Examples.* The following examples illustrate this paragraph (f)(3)(iii):

Example 1. Foreign Parent (FP) and U.S. Subsidiary (USS) both produce a feedstock for the manufacture of various high-performance plastic products. Producing the feedstock requires large amounts of electricity, which accounts for a significant portion of its production cost. FP and USS enter into a cost sharing arrangement to develop a new process that will reduce the amount of electricity required to produce a unit of the feedstock. FP and USS currently both incur an electricity cost of X% of its other production costs and rates for each are expected to remain similar in the future. How much the new process, if it is successful, will reduce the amount of electricity required to produce a unit of the feedstock is uncertain, but it will be about the same amount for both companies. Therefore, the cost savings each company is expected to achieve after implementing the new process are similar relative to the total amount of the feedstock produced. Under the cost sharing arrangement FP and USS divide the costs of developing the new process based on the units of the feedstock each is anticipated to produce in the future. In this case, units produced is the most reliable basis for measuring benefits and dividing the intangible development costs because each participant is expected to have a similar decrease in costs per unit of the feedstock produced.

Example 2. The facts are the same as in *Example 1,* except that USS pays X% of its other production costs for electricity while FP pays 2X% of its other production costs. In this case, units produced is not the most reliable basis for measuring benefits and dividing the intangible development costs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The district director determines that the most reliable measure of benefit shares may be based on units of the feedstock produced if FP's units are weighted relative to USS' units by a factor of 2. This reflects the fact that FP pays twice as much as USS as a percentage of its other production costs for electricity and, therefore, FP's savings per unit of the feedstock would be twice USS's savings from any new process eventually developed.

Example 3. The facts are the same as in *Example 2,* except that to supply the particular needs of the U.S. market USS manufactures the feedstock with somewhat different properties than FP's feedstock. This requires USS to employ a somewhat different production process than does FP. Because of this difference, it will be more costly for USS to adopt any new process that may be developed under the cost sharing agreement. In this case, units produced is not the most reliable basis for measuring benefit shares. In order to reliably determine benefit shares, the district director offsets the reasonably anticipated costs of adopting the new process against the reasonably anticipated total savings in electricity costs.

Example 4. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new anesthetic drugs. USP obtains the right to use any resulting patent in the U.S. market, and FS obtains the right to use the patent in the European market. USP and FS divide costs on the basis of anticipated operating profit from each patent under development. USP anticipates that it will receive a much higher profit than FS per unit sold because drug prices are uncontrolled in the U.S., whereas drug prices are regulated in many European countries. In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 5. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) both manufacture and sell fertilizers. They enter into a cost sharing arrangement to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the cost sharing arrangement, USS obtains the rights to produce and sell the new form of fertilizer for the U.S. market while FP obtains the rights to produce and sell the fertilizer for the rest of the world. The costs of developing the new form of fertilizer are divided on the basis of the anticipated sales of fertilizer in the participants' respective markets.

(ii) If the research and development is successful the pellet form will deliver the fertilizer more efficiently to crops and less fertilizer will be required to achieve the same effect on crop growth. The pellet form of fertilizer can be expected to sell at a price premium over the powder form of fertilizer based on the savings in the amount of fertilizer that needs to be used. If the research and development is successful, the costs of producing pellet fertilizer are expected to be approximately the same as the costs of producing powder fertilizer and the same for both FP and USS. Both FP and USS operate at approximately the same market levels, selling their fertilizers largely to independent distributors.

(iii) In this case, the controlled taxpayers' basis for measuring benefits is the most reliable.

Example 6. The facts are the same as in *Example 5,* except that FP distributes its fertilizers directly while USS sells to independent distributors. In this case, sales of USS and FP are not the most reliable basis for measuring benefits unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 7. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop materials that will be used to train all new entry-level employees. FP and USS determine that the new materials will save approximately ten hours of training time per employee. Because their entry-level employees are paid on differing wage scales, FP and USS decide that they should not divide costs based on the number of entry-level employees hired by each. Rather, they divide costs based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring benefits is the most reliable because there is a direct relationship between compensation paid to new entry-level employees and costs saved by FP and USS from the use of the new training materials.

Example 8. U.S. Parent (USP), Foreign Subsidiary 1 (FS1) and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop computer software that each will market and install on customers' computer systems. The participants divide costs on the basis of projected sales by USP, FS1, and FS2 of the software in their respective geographic areas. However, FS1 plans not only to sell but also to license the software to unrelated customers, and FS1's licensing income (which is a percentage of the licensees' sales) is not counted in the projected benefits. In this case, the basis used for measuring the benefits of each participant is not the most reliable because all of the benefits received by participants are not taken into account. In order to reliably determine benefit shares, FS1's projected benefits from licensing must be included in the measurement on a basis that is the same as that used to measure its own and the other participants' projected benefits from sales (e.g., all participants might measure their benefits on the basis of operating profit).

(iv) *Projections used to estimate anticipated benefits*—(A) *In general.* The reliability of an estimate of anticipated benefits also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently benefit shares are expected to vary significantly over the years in which benefits will be received, it may be necessary to use the present discounted value of the projected benefits to reliably determine each controlled participant's share of those benefits. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares. This circumstance is most likely to occur when the cost sharing arrangement is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the covered intangibles is unlikely to change, the covered intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Unreliable projections.* A significant divergence between projected benefit shares and actual benefit shares may indicate that the projections were not reliable. In such a case, the district director may use actual benefits as the most reliable measure of anticipated benefits. If benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. Projections will not be considered unreliable based on a divergence between a controlled participant's projected benefit share and actual benefit share if the amount of such divergence for every controlled participant is less than or equal to 20% of the participant's projected benefit share. Further, the district director will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the participants, that could not reasonably have been anticipated at the time that costs were shared. For purposes of this paragraph, all controlled participants that are not U.S.

persons will be treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection will be made to the cost shares of foreign controlled participants only if there is a matching adjustment to the cost shares of controlled participants that are U.S. persons. Nothing in this paragraph (f)(3)(iv)(B) will prevent the district director from making an allocation if the taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures anticipated benefits based on units sold, and the district director determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

(C) *Foreign-to-foreign adjustments.* Notwithstanding the limitations on adjustments provided in paragraph (f)(3)(iv)(B) of this section, adjustments to cost shares based on an unreliable projection also may be made solely among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

(D) *Examples.* The following examples illustrate this paragraph (f)(3)(iv):

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop a new car model. The participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears 66⅔% of each year's intangible development costs and FP bears 33⅓% of such costs.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. The district director determines that in order to reflect USS' one-year lag in introducing new car models, a more reliable projection of each participant's share of benefits would be based on a projection of all four years of sales for each participant, discounted to present value.

Example 2. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new and improved household cleaning products. Both participants have sold household cleaning products for many years and have stable market shares. The products under development are unlikely to produce unusual profits for either participant. The participants divide costs on the basis of each participant's current sales of household cleaning products. In this case, the participants' future benefit shares are reliably projected by current sales of cleaning products.

Example 3. The facts are the same as in *Example 2,* except that FS's market share is rapidly expanding because of the business failure of a competitor in its geographic area. The district director determines that the participants' future benefit shares are not reliably projected by current sales of cleaning products and that FS's benefit projections should take into account its growth in sales.

Example 4. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop synthetic fertilizers and insecticides. FP and USS share costs on the basis of each participant's current sales of fertilizers and insecticides. The market shares of the participants have been stable for fertilizers, but FP's market share for insecticides has been expanding. The district director determines that the participants' projections of benefit shares are reliable with regard to fertilizers, but not reliable with regard to insecticides; a more reliable projection of benefit shares would take into account the expanding market share for insecticides.

Example 5. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a cost sharing arrangement to develop new food products, dividing costs on the basis of projected sales two years in the future. In year 1, USP and FS project that their sales in year 3 will be equal, and they divide costs accordingly. In year 3, the district director examines the participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The district director agrees that sales two years in the future provide a reliable basis for estimating benefit shares. Because the differences between USP's and FS's actual and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for year 3 is reliable.

Example 6. The facts are the same as in *Example 5,* except that the in year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and actual benefit shares is greater than 20% of USP's projected benefit share and is not due to an extraordinary event beyond the control of the participants. The district director concludes that the projection of anticipated benefit shares was unreliable, and uses actual benefits as the basis for an adjustment to the cost shares borne by USP and FS.

Example 7. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter a cost sharing arrangement in year 1. They project that they will begin to receive benefits from covered intangibles in years 4 through 6, and that USP will receive 60% of total benefits and FS 40% of total benefits. In years 4 through 6, USP and FS actually receive 50% each of the total benefits. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. Although USP's actual benefit share (50%) is within 20% of its projected benefit share (60%), FS's actual benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the district director may conclude that the participants' projections were not reliable and may use actual benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 8. Three controlled taxpayers, USP, FS1 and FS2 enter into a cost sharing arrangement. FS1 and FS2 are foreign. USP is a United States corporation that controls all the stock of FS1 and FS2. The participants project that they will share the total benefits of the covered intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Actual benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the participants' projections, the district director compares these actual benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single participant. The actual benefit share received by USP (45%) is within 20% of its projected benefit share (50%). In addition, the non-US participants' actual benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the district director concludes that the participants' projections of future benefits were reliable, despite the fact that FS2's actual benefit share (30%) is not within 20% of its projected benefit share (20%).

Example 9. The facts are the same as in *Example 8.* In addition, the district director determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the district director concludes that the participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce FS1's earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to §1.482–7 (f)(3)(iv)(C), the district director may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2's projection of future benefits was unreliable and the variation between actual and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

Example 10. (i)(A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement in 1996 to develop a new treatment for baldness. USS's interest in any treatment developed is the right to produce and sell the treatment in the U.S. market while FP retains rights to produce and sell the treatment in the rest of the world. USS and FP measure their anticipated benefits from the cost sharing arrangement based on their respective projected future sales of the baldness treatment. The following sales projections are used:

SALES

[In millions of dollars]

Year	USS	FP
1997	5	10
1998	20	20
1999	30	30
2000	40	40
2001	40	40
2002	40	40
2003	40	40
2004	20	20
2005	10	10
2006	5	5

(B) In 1997, the first year of sales, USS is projected to have lower sales than FP due to lags in U.S. regulatory approval for the baldness treatment. In each subsequent year USS and FP are projected to have equal sales. Sales are projected to build over the first three years of the period, level off for several years, and then decline over the final years of the period as new and improved baldness treatments reach the market.

(ii) To account for USS's lag in sales in the first year, the present discounted value of sales over the period is used as the basis for measuring benefits. Based on the risk associated with this venture, a discount rate of 10 percent is selected. The present discounted value of projected sales is determined to be approximately $154.4 million for USS and $158.9 million for FP. On this basis USS and FP are projected to obtain approximately 49.3% and 50.7% of the benefit, respectively, and the costs of developing the baldness treatment are shared accordingly.

(iii) (A) In the year 2002 the district director examines the cost sharing arrangement. USS and FP have obtained the following sales results through the year 2001:

SALES

[In millions of dollars]

Year	USS	FP
1997	0	17
1998	17	35
1999	25	41
2000	38	41
2001	39	41

(B) USS's sales initially grew more slowly than projected while FP's sales grew more quickly. In each of the first three years of the period the share of total sales of at least one of the parties diverged by over 20% from its projected share of sales. However, by the year 2001 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and all the facts and circumstances, the district director determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $141.6 million for USS and $187.3 million for FP. This result implies that USS and FP obtain approximately 43.1% and 56.9%, respectively, of the anticipated benefits from the baldness treatment. Because these benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the district director determines that, based on the difference between actual and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between actual and projected benefit shares.

Example 11. (i) The facts are the same as in *Example 10,* except that the actual sales results through the year 2001 are as follows:

SALES

[In millions of dollars]

Year	USS	FP
1997	0	17
1998	17	35
1999	25	44
2000	34	54
2001	36	55

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the district director determines that for the remaining years the following sales projections are more reliable than the original projections:

SALES

[In millions of dollars]

Year	USS	FP
2002	36	55
2003	36	55
2004	18	28
2005	9	14
2006	4.5	7

(iii) Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.2 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 35.4% and 63.6%, respectively, of the anticipated benefits from the baldness treatment. These benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the district director determines that, based on the difference between actual and projected benefit shares, the original projections were unreliable. The district director adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(4) *Timing of allocations.* If the district director reallocates costs under the provisions of this paragraph (f), the allocation must be reflected for tax purposes in the year in which the costs were incurred. When a cost sharing payment is owed by one member of a qualified cost sharing arrangement to another member, the district director may make appropriate allocations to reflect an arm's length rate of interest for the time value of money, consistent with the provisions of § 1.482–2(a) (Loans or advances).

(g) *Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in)*—(1) *In general.* A controlled participant that makes intangible property available to a qualified cost sharing arrangement will be treated as having transferred interests in such property to the other controlled participants, and such other controlled participants must make buy-in payments to it, as provided in paragraph (g)(2) of this section. If the other controlled participants fail to make such payments, the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transferred intangible property. Further, if a group of controlled taxpayers participates in a qualified cost sharing arrangement, any change in the controlled participants' interests in covered intangibles, whether by reason of entry of a new participant or otherwise by reason of transfers (including deemed transfers) of interests among existing participants, is a transfer of intangible property, and the district director may make appropriate allocations, under the provisions of §§ 1.482–1 and 1.482–4 through 1.482–6, to reflect an arm's length consideration for the transfer. See paragraphs (g) (3), (4), and (5) of this section. Paragraph (g)(6) of this section provides rules for assigning unassigned interests under a qualified cost sharing arrangement.

(2) *Pre-existing intangibles.* If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§1.482–1 and 1.482–4 through 1.482–6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced to the extent of any payments owed to it under this paragraph (g)(2) from other controlled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. See paragraph (g)(8), *Example 4,* of this section. Such payments will be treated as consideration for a transfer of an interest in the intangible property made available to the qualified cost sharing arrangement by the payee. Any payment to or from an uncontrolled participant in consideration for intangible property made available to the qualified cost sharing arrangement will be shared by the controlled participants in accordance with their shares of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). A controlled participant's payment required under this paragraph (g)(2) is deemed to be reduced by such a share of payments owed from an uncontrolled participant to the same extent as by any payments owed from other controlled participants under this paragraph (g)(2). See paragraph (g)(8), *Example 5,* of this section.

(3) *New controlled participant.* If a new controlled participant enters a qualified cost sharing arrangement and acquires any interest in the covered intangibles, then the new participant must pay an arm's length consideration, under the provisions of §§1.482–1 and 1.482–4 through 1.482–6, for such interest to each controlled participant from whom such interest was acquired.

(4) *Controlled participant relinquishes interests.* A controlled participant in a qualified cost sharing arrangement may be deemed to have acquired an interest in one or more covered intangibles if another controlled participant transfers, abandons, or otherwise relinquishes an interest under the arrangement, to the benefit of the first participant. If such a relinquishment occurs, the participant relinquishing the interest must receive an arm's length consideration, under the provisions of §§1.482–1 and 1.482–4 through 1.482–6, for its interest. If the controlled participant that has relinquished its interest subsequently uses that interest, then that participant must pay an arm's length consideration, under the provisions of §§1.482–1 and 1.482–4 through 1.482–6, to the controlled participant that acquired the interest.

(5) *Conduct inconsistent with the terms of a cost sharing arrangement.* If, after any cost allocations authorized by paragraph (a)(2) of this section, a controlled participant bears costs of intangible development that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, then the district director may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the cost sharing arrangement. In such a case, the district director may disregard such terms and impute an agreement consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater share of costs received additional interests in covered intangibles. See §1.482–1(d)(3)(ii)(B) (Identifying contractual terms) and §1.482- 4(f)(3)(ii) (Identification of owner). Accordingly, that participant must receive an arm's length payment from any controlled participant whose share of the intangible development costs is less than its share of reasonably anticipated benefits over time, under the provisions of §§1.482–1 and 1.482–4 through 1.482–6.

(6) *Failure to assign interests under a qualified cost sharing arrangement.* If a qualified cost sharing arrangement fails to assign an interest in a covered intangible, then each controlled participant will be deemed to hold a share in such interest equal to its share of the costs of developing such intangible. For this purpose, if cost shares have varied materially over the period during which such intangible was developed, then the costs of developing the intangible must be measured by their present discounted value as of the date when the first such costs were incurred.

(7) *Form of consideration.* The consideration for an acquisition described in this paragraph (g) may take any of the following forms:

(i) *Lump sum payments.* For the treatment of lump sum payments, see §1.482–4(f)(5) (Lump sum payments);

(ii) *Installment payments.* Installment payments spread over the period of use of the intangible by the transferee, with interest calculated in accordance with §1.482–2(a) (Loans or advances); and

(iii) *Royalties.* Royalties or other payments contingent on the use of the intangible by the transferee.

(8) *Examples.* The following examples illustrate allocations described in this paragraph (g):

Example 1. In year one, four members of a controlled group enter into a cost sharing arrangement to develop a commercially feasible process for capturing energy from nuclear fusion. Based on a reliable projection of their future benefits, each cost sharing participant bears an equal share of the costs. The cost of developing intangibles for each participant with respect to the project is approximately $1 million per year. In year ten, a fifth member of the controlled group joins the cost sharing group and agrees to bear one-fifth of the future costs in exchange for part of the fourth member's territory reasonably anticipated to yield benefits amounting to one-fifth of the total benefits. The fair market value of intangible property within the arrangement at the time the fifth company joins the arrangement is $45 million. The new member must pay one-fifth of that amount (that is, $9 million total) to the fourth member from whom it acquired its interest in covered intangibles.

Example 2. U.S. Subsidiary (USS), Foreign Subsidiary (FS) and Foreign Parent (FP) enter into a cost sharing arrangement to develop new products within the Group X product line. USS manufactures and sells Group X products in North America, FS manufactures and sells Group X products in South America, and FP manufactures and sells Group X products in the rest of the world. USS, FS and FP project that each will manufacture and sell a third of the Group X products under development, and they share costs on the basis of projected sales of manufactured products. When the new Group X products are developed, however, USS ceases to manufacture Group X products, and FP sells its Group X products to USS for resale in the North American market. USS earns a return on its resale activity that is appropriate given its function as a distributor, but does not earn a return attributable to exploiting covered intangibles. The district director determines that USS' share of the costs (one-third) was greater than its share of reasonably anticipated benefits (zero) and that it has transferred an interest in the intangibles for which it should receive a payment from FP, whose share of the intangible development costs (one-third) was less than its share of reasonably anticipated benefits over time (two-thirds). An allocation is made under §§1.482–1 and 1.482–4 through 1.482–6 from FP to USS to recognize USS' one-third interest in the intangibles. No allocation is made from FS to USS because FS did not exploit USS' interest in covered intangibles.

Example 3. U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a cost sharing arrangement to develop a cure for the common cold. Costs are shared USP–50%, FS1–40% and FS2–10% on the basis of projected units of cold medicine to be produced by each. After ten years of research and development, FS1 withdraws from the arrangement, transferring its interests in the intangibles under development to USP in exchange for a lump sum payment of $10 million. The district director may review this lump sum payment, under the provisions of §1.482–4(f)(5), to ensure that the amount is commensurate with the income attributable to the intangibles.

Example 4. (i) Four members A, B, C, and D of a controlled group form a cost sharing arrangement to develop the next generation technology for their business. Based on a reliable projection of their future benefits, the participants agree to bear shares of the costs incurred during the term of the agreement in the following percentages: A 40%; B 15%; C 25%; and D 20%. The arm's length charges, under the rules of §§1.482–1 and 1.482–4 through 1.482–6, for the use of the existing intangible property they respectively make available to the cost sharing arrangement are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final buy-in payments/receipts among A, B, C, and D are shown in the table as follows:

[All amounts stated in X's]

	A	B	C	D
Payments	<40>	<21>	<37.5>	<30>
Receipts	48	34	22.5	24
Final	8	13	<15>	<6>

(ii) The first row/first column shows A's provisional buy-in payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A's share of anticipated benefits of 40%. The second row/first column shows A's provisional buy-in receipts equal to the sum of the products of 80X and B's, C's, and D's anticipated benefits shares (15%, 25%, and 20%, respectively). The other entries in the first two rows of the table are similarly computed. The last row shows the final buy-in receipts/payments after offsets. Thus, for the taxable year, A and B are treated as receiving the 8X and 13X, respectively, pro rata out of payments by C and D of 15X and 6X, respectively.

Example 5. A and B, two members of a controlled group form a cost sharing arrangement with an unrelated third party C to develop a new technology useable in their respective businesses. Based on a reliable projection of their future benefits, A and B agree to bear shares of 60% and 40%, respectively, of the costs incurred during the term of the agreement. A also makes available its existing technology for purposes of the research to be undertaken. The arm's length charge, under the rules of §§1.482–1 and 1.482–4 through 1.482–6, for the use of the existing technology is 100X for the taxable year. Under its agreement with A and B, C must make a specified cost sharing payment as well as a payment of 50X for the taxable year on account of the pre- existing intangible property made available to the cost sharing arrangement. B's provisional buy-in payment (before offsets) to A for the taxable year is 40X (the product of 100X and B's anticipated benefits share of 40%). C's payment of 50X is shared provisionally between A and B in accordance with their shares of reasonably anticipated benefits, 30X (50X times 60%) to A and 20X (50X times 40%) to B. B's final buy-in payment (after offsets) is 20X (40X less 20X). A is treated as receiving the 70X total provisional payments (40X plus 30X) pro rata out of the final payments by B and C of 20X and 50X, respectively.

(h) *Character of payments made pursuant to a qualified cost sharing arrangement*—(1) *In general.* Payments made pursuant to a qualified cost sharing arrangement (other than payments described in paragraph (g) of this section) generally will be considered costs of developing intangibles of the payor and reimbursements of the same kind of costs of developing intangibles of the payee. For purposes of this paragraph (h), a controlled participant's payment required under a qualified cost sharing arrangement is deemed to be reduced to the extent of any payments owed to it under the arrangement from other controlled or uncontrolled participants. Each payment received by a payee will be treated as coming pro rata out of payments made by all payors. Such payments will be applied pro rata against deductions for the taxable year that the payee is allowed in connection with the qualified cost sharing arrangement. Payments received in excess of such deductions will be treated as in consideration for use of the tangible property made available to the qualified cost sharing arrangement by the payee. For purposes of the research credit determined under section 41, cost sharing payments among controlled participants will be treated as provided for intra-group transactions in §1.41–6(e). Any payment made or received by a taxpayer pursuant to an arrangement that the district director determines not to be a qualified cost sharing arrangement, or a payment made or received pursuant to paragraph (g) of this section, will be subject to the provisions of §§1.482–1 and 1.482–4 through 1.482–6. Any payment that in substance constitutes a cost sharing payment will be treated as such for purposes of this section, regardless of its characterization under foreign law.

(2) *Examples.* The following examples illustrate this paragraph (h):

Example 1. U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a cost sharing arrangement to develop a miniature widget, the Small R. Based on a reliable projection of their future benefits, USP agrees to bear 40% and FS to bear 60% of the costs incurred during the term of the agreement. The principal costs in the intangible development area are operating expenses incurred by FS in Country Z of 100X annually, and operating expenses incurred by USP in the United States also of 100X annually. Of the total costs of 200X, USP's share is 80X and FS's share is 120X, so that FS must make a payment to USP of 20X. This payment will be treated as a reimbursement of 20X of USP's operating expenses in the United States. Accordingly, USP's Form 1120 will reflect an 80X deduction on account of activities performed in the United States for purposes of allocation and apportionment of the deduction to source. The Form 5471 for FS will reflect a 100X deduction on account of activities performed in Country Z, and a 20X deduction on account of activities performed in the United States.

Example 2. The facts are the same as in *Example 1,* except that the 100X of costs borne by USP consist of 5X of operating expenses incurred by USP in the United States and 95X of fair market value rental cost for a facility in the United States. The depreciation deduction attributable to the U.S. facility is 7X. The 20X net payment by FS to USP will first be applied in reduction pro rata of the 5X deduction for operating expenses and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

(i) *Accounting requirements.* The accounting requirements of this paragraph are that the controlled participants in a qualified cost sharing arrangement must use a consistent method of accounting to measure costs and benefits, and must translate foreign currencies on a consistent basis.

(j) *Administrative requirements*—(1) *In general.* The administrative requirements of this paragraph consist of the documentation requirements of paragraph (j)(2) of this section and the reporting requirements of paragraph (j)(3) of this section.

(2) *Documentation*—(i) *Requirements.* A controlled participant must maintain sufficient documentation to establish that the requirements of paragraphs (b)(4) and (c)(1) of this section have been met, as well as the additional documentation specified in this paragraph (j)(2)(i), and must provide any such documentation to the Internal Revenue Service within 30 days of a request (unless an extension is granted by the district director). Documents necessary to establish the following must also be maintained—

(A) The total amount of costs incurred pursuant to the arrangement;

(B) The costs borne by each controlled participant;

(C) A description of the method used to determine each controlled participant's share of the intangible development costs, including the projections used to estimate benefits, and an explanation of why that method was selected;

(D) The accounting method used to determine the costs and benefits of the intangible development (including the method used to translate foreign currencies), and, to the extent that the method materially differs from U.S. generally accepted accounting principles, an explanation of such material differences;

(E) Prior research, if any, undertaken in the intangible development area, any tangible or intangible property made available for use in the arrangement, by each controlled participant, and any information used to establish the value of pre-existing and covered intangibles; and

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of covered intangibles.

(ii) *Coordination with penalty regulation.* The documents described in paragraph (j)(2)(i) of this section will satisfy the principal documents requirement under §1.6662–6(d)(2)(iii)(B) with respect to a qualified cost sharing arrangement.

(3) *Reporting requirements.* A controlled participant must attach to its U.S. income tax return a statement indicating that it is a participant in a qualified cost sharing arrangement, and listing the other controlled participants in the arrangement. A controlled participant that is not required to file a U.S. income tax return must ensure that such a statement is attached to Schedule M of any Form 5471 or to any Form 5472 filed with respect to that participant.

(k) *Effective date.* This section applies for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2) and (j)(2)(i)(F) of this section apply for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

(l) *Transition rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this section, if, prior to January 1, 1996, the arrangement was a bona fide cost sharing arrangement under the provisions of § 1.482–7T (as contained in the 26 CFR part 1 edition revised as of April 1, 1995), but only if the arrangement is amended, if necessary, to conform with the provisions of this section by December 31, 1996.

[T.D. 8632, 60 FR 65557, Dec. 20, 1995, as amended by T.D. 8670, 61 FR 21956, May 13, 1996; 61 FR 33656, June 28, 1996; T.D. 8930, 66 FR 295, Jan. 3, 2001; T.D. 9088, 68 FR 51177, Aug. 26, 2003; 69 FR 13473, Mar. 23, 2004]

§ 1.482–8 Examples of the best method rule.

In accordance with the best method rule of § 1.482–1(c), a method may be applied in a particular case only if the comparability, quality of data, and reliability of assumptions under that method make it more reliable than any other available measure of the arm's length result. The following examples illustrate the comparative analysis required to apply this rule. As with all of the examples in these regulations, these examples are based on simplified facts, are provided solely for purposes of illustrating the type of analysis required under the relevant rule, and do not provide rules of general application. Thus, conclusions reached in these examples as to the relative reliability of methods are based on the assumed facts of the examples, and are not general conclusions concerning the relative reliability of any method.

Example 1. Preference for comparable uncontrolled price method. Company A is the U.S. distribution subsidiary of Company B, a foreign manufacturer of consumer electrical appliances. Company A purchases toaster ovens from Company B for resale in the U.S. market. To exploit other outlets for its toaster ovens, Company B also sells its toaster ovens to Company C, an unrelated U.S. distributor of toaster ovens. The products sold to Company A and Company C are identical in every respect and there are no material differences between the transactions. In this case application of the CUP method, using the sales of toaster ovens to Company C, generally will provide a more reliable measure of an arm's length result for the controlled sale of toaster ovens to Company A than the application of any other method. See §§ 1.482–1(c)(2)(i) and –3(b)(2)(ii)(A).

Example 2. Resale price method preferred to comparable uncontrolled price method. The facts are the same as in Example 1, except that the toaster ovens sold to Company A are of substantially higher quality than those sold to Company C and the effect on price of such quality differences cannot be accurately determined. In addition, in order to round out its line of consumer appliances Company A purchases blenders from unrelated parties for resale in the United States. The blenders are resold to substantially the same customers as the toaster ovens, have a similar resale value to the toaster ovens, and are purchased under similar terms and in similar volumes. The distribution functions performed by Company A appear to be similar for toaster ovens and blenders. Given the product differences between the toaster ovens, application of the resale price method using the purchases and resales of blenders as the uncontrolled comparables is likely to provide a more reliable measure of an arm's length result than application of the comparable uncontrolled price method using Company B's sales of toaster ovens to Company C.

Example 3. Resale price method preferred to comparable profits method. (i) The facts are the same as in *Example 2* except that Company A purchases all its products from Company B and Company B makes no uncontrolled sales into the United States. However, six uncontrolled U.S. distributors are identified that purchase a similar line of products from unrelated parties. The uncontrolled distributors purchase toaster ovens from unrelated parties, but there are significant differences in the characteristics of the toaster ovens, including the brandnames under which they are sold.

(ii) Under the facts of this case, reliable adjustments for the effect of the different brandnames cannot be made. Except for some differences in payment terms and inventory levels, the purchases and resales of toaster ovens by the three uncontrolled distributors are closely similar to the controlled purchases in terms of the markets in which they occur, the volume of the transactions, the marketing activities undertaken by the distributor, inventory levels, warranties, allocation of currency risk, and other relevant functions and risks. Reliable adjustments can be made for the differences in payment terms and inventory levels. In addition, sufficiently detailed accounting information is available to permit adjustments to be made for differences in accounting methods or in reporting of costs between cost of goods sold and operating expenses. There are (a)(3), (d)(2) and (j)(2)(i)(F) of this section apply for stock-based compensation granted in taxable years beginning on or after August 26, 2003.

(l) *Transition rule.* A cost sharing arrangement will be considered a qualified cost sharing arrangement, within the meaning of this section, if, prior to January 1, 1996, the arrangement was a bona fide cost sharing arrangement under the provisions of § 1.482–7T (as contained in the 26 CFR part 1 edition revised as of April 1, 1995), but only if the arrangement is amended, if necessary, to conform with the provisions of this section by December 31, 1996.

[T.D. 8632, 60 FR 65557, Dec. 20, 1995, as amended by T.D. 8670, 61 FR 21956, May 13, 1996; 61 FR 33656, June 28, 1996; T.D. 8930, 66 FR 295, Jan. 3, 2001; T.D. 9088, 68 FR 51177, Aug. 26, 2003; 69 FR 13473, Mar. 23, 2004]

§ 1.482–8 Examples of the best method rule.

In accordance with the best method rule of § 1.482–1(c), a method may be applied in a particular case only if the comparability, quality of data, and reliability of assumptions under that method make it more reliable than any other available measure of the arm's length result. The following examples illustrate the comparative analysis required to apply this rule. As with all of the examples in these regulations, these examples are based on simplified facts, are provided solely for purposes of illustrating the type of analysis required under the relevant rule, and do not provide rules of general application. Thus, conclusions reached in these examples as to the relative reliability of methods are based on the assumed facts of the examples, and are not general conclusions concerning the relative reliability of any method.

Example 1. Preference for comparable uncontrolled price method. Company A is the U.S. distribution subsidiary of Company B, a foreign manufacturer of consumer electrical appliances. Company A purchases toaster ovens from Company B for resale in the U.S. market. To exploit other outlets for its toaster ovens, Company B also sells its toaster ovens to Company C, an unrelated U.S. distributor of toaster ovens. The products sold to Company A and Company C are identical in every respect and there are no material differences between the transactions. In this case application of the CUP method, using the sales of toaster ovens to Company C, generally will provide a more reliable measure of an arm's length result for the controlled sale of toaster ovens to Company A than the application of any other method. See §§ 1.482–1(c)(2)(i) and –3(b)(2)(ii)(A).

Example 2. Resale price method preferred to comparable uncontrolled price method. The facts are the same as in Example 1, except that the toaster ovens sold to Company A are of substantially higher quality than those sold to Company C and the effect on price of such quality differences cannot be accurately determined. In addition, in order to round out its line of consumer appliances Company A purchases blenders from unrelated parties for resale in the United States. The blenders are resold to substantially the same customers as the toaster ovens, have a similar resale value to the toaster ovens, and are purchased under similar terms and in similar volumes. The distribution functions performed by Company A appear to be similar for toaster ovens and blenders. Given the product differences between the toaster ovens, application of the resale price method using the purchases and resales of blenders as the uncontrolled comparables is likely to provide a more reliable measure of an arm's length result than application of the comparable uncontrolled price method using Company B's sales of toaster ovens to Company C.

Example 3. Resale price method preferred to comparable profits method. (i) The facts are the same as in *Example 2* except that Company A purchases all its products from Company B and Company B makes no uncontrolled sales into the United States. However, six uncontrolled U.S. distributors are identified that purchase a similar line of products from unrelated parties. The uncontrolled distributors purchase toaster ovens from unrelated parties, but there are significant differences in the characteristics of the toaster ovens, including the brandnames under which they are sold.

(ii) Under the facts of this case, reliable adjustments for the effect of the different brandnames cannot be made. Except for some differences in payment terms and inventory levels, the purchases and resales of toaster ovens by the three uncontrolled distributors are closely similar to the controlled purchases in terms of the markets in which they occur, the volume of the transactions, the marketing activities undertaken by the distributor, inventory levels, warranties, allocation of currency risk, and other relevant functions and risks. Reliable adjustments can be made for the differences in payment terms and inventory levels. In addition, sufficiently detailed accounting information is available to permit adjustments to be made for differences in accounting methods or in reporting of costs between cost of goods sold and operating expenses. There are no other material differences between the controlled and uncontrolled transactions.

(iii) Because reliable adjustments for the differences between the toaster ovens, including the trademarks under which they are sold, cannot be made, these uncontrolled transactions will not serve as reliable measures of an arm's length result under the comparable uncontrolled price method. There is, however, close functional similarity between the controlled and uncontrolled transactions and reliable adjustments have been made for material differences that would be likely to affect gross profit. Under these circumstances, the gross profit margins derived under the resale price method are less likely to be susceptible to any unidentified differences than the operating profit measures used under the comparable profits method. Therefore, given the close functional comparability between the controlled and uncontrolled transactions, and the high quality of the data, the resale price method achieves a higher degree of comparability and will provide a more reliable measure of an arm's length result. See §1.482–1(c) (Best method rule).

Example 4. Comparable profits method preferred to resale price method. The facts are the same as in *Example 3,* except that the accounting information available for the uncontrolled comparables is not sufficiently detailed to ensure consistent reporting between cost of goods sold and operating expenses of material items such as discounts, insurance, warranty costs, and supervisory, general and administrative expenses. These expenses are significant in amount. Therefore, whether these expenses are treated as costs of goods sold or operating expenses would have a significant effect on gross margins. Because in this case reliable adjustments can not be made for such accounting differences, the reliability of the resale price method is significantly reduced. There is, however, close functional similarity between the controlled and uncontrolled transactions and reliable adjustments have been made for all material differences other than the potential accounting differences. Because the comparable profits method is not adversely affected by the potential accounting differences, under these circumstances the comparable profits method is likely to produce a more reliable measure of an arm's length result than the resale price method. See §1.482–1(c) (Best method rule).

Example 5. Cost plus method preferred to comparable profits method. (i) USS is a U.S. company that manufactures machine tool parts and sells them to its foreign parent corporation, FP. Four U.S. companies are identified that also manufacture various types of machine tool parts but sell them to uncontrolled purchasers.

(ii) Except for some differences in payment terms, the manufacture and sales of machine tool parts by the four uncontrolled companies are closely similar to the controlled transactions in terms of the functions performed and risks assumed. Reliable adjustments can be made for the differences in payment terms. In addition, sufficiently detailed accounting information is available to permit adjustments to be made for differences between the controlled transaction and the uncontrolled comparables in accounting methods and in the reporting of costs between cost of goods sold and operating expenses.

(iii) There is close functional similarity between the controlled and uncontrolled transactions and reliable adjustments can be made for material differences that would be likely to affect gross profit. Under these circumstances, the gross profit markups derived under the cost plus method are less likely to be susceptible to any unidentified differences than the operating profit measures used under the comparable profits method. Therefore, given the close functional comparability between the controlled and uncontrolled transactions, and the high quality of the data, the cost plus method achieves a higher degree of comparability and will provide a more reliable measure of an arm's length result. See §1.482–1(c) (Best method rule).

Example 6. Comparable profits method preferred to cost plus method. The facts are the same as in *Example 5,* except that there are significant differences between the controlled and uncontrolled transactions in terms of the types of parts and components manufactured and the complexity of the manufacturing process. The resulting functional differences are likely to materially affect gross profit margins, but it is not possible to identify the specific differences and reliably adjust for their effect on gross profit. Because these functional differences would be reflected in differences in operating expenses, the operating profit measures used under the comparable profits method implicitly reflect to some extent these functional differences. Therefore, because in this case the comparable profits method is less sensitive than the cost plus method to the potentially significant functional differences between the controlled and uncontrolled transactions, the comparable profits method is likely to produce a more reliable measure of an arm's length result than the cost plus method. See §1.482–1(c) (Best method rule).

Example 7. Preference for comparable uncontrolled transaction method. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that 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 foreign countries.

(ii) USpharm licenses its subsidiary in country X, Xpharm, to produce and sell drug Z in country X. At the same time, it licenses 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 protection for intellectual property rights. Country X and country Y are similar countries in terms of population, per capita income and the incidence of disease zeezee. Consequently, drug Z is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing drug Z in each country are expected to be approximately the same.

(iii) USpharm and Xpharm establish terms for the license of drug Z that are identical in every material respect, including royalty rate, to the terms established between USpharm and Ydrug. In this case the district director determines that the royalty rate established in the Ydrug license agreement is a reliable measure of the arm's length royalty rate for the Xpharm license agreement. Given that the same property is transferred in the controlled and uncontrolled transactions, and that the circumstances under which the transactions occurred are substantially the same, in this case the comparable uncontrolled transaction method is likely to provide a more reliable measure of an arm's length result than any other method. See § 1.482–4(c)(2)(ii).

Example 8. Residual profit split method preferred to other methods. (i) USC is a U.S. company that develops, manufactures and sells communications equipment. EC is the European subsidiary of USC. EC is an established company that carries out extensive research and development activities and develops, manufactures and sells communications equipment in Europe. There are extensive transactions between USC and EC. USC licenses valuable technology it has developed to EC for use in the European market but EC also licenses valuable technology it has developed to USC. Each company uses components manufactured by the other in some of its products and purchases products from the other for resale in its own market.

(ii) Detailed accounting information is available for both USC and EC and adjustments can be made to achieve a high degree of consistency in accounting practices between them. Relatively reliable allocations of costs, income and assets can be made between the business activities that are related to the controlled transactions and those that are not. Relevant marketing and research and development expenditures can be identified and reasonable estimates of the useful life of the related intangibles are available so that the capitalized value of the intangible development expenses of USC and EC can be calculated. In this case there is no reason to believe that the relative value of these capitalized expenses is substantially different from the relative value of the intangible property of USC and EC. Furthermore, comparables are identified that could be used to estimate a market return for the routine contributions of USC and EC. Based on these facts, the residual profit split could provide a reliable measure of an arm's length result.

(iii) There are no uncontrolled transactions involving property that is sufficiently comparable to much of the tangible and intangible property transferred between USC and EC to permit use of the comparable uncontrolled price method or the comparable uncontrolled transaction method. Uncontrolled companies are identified in Europe and the United States that perform somewhat similar activities to USC and EC; however, the activities of none of these companies are as complex as those of USC and EC and they do not use similar levels of highly valuable intangible property that they have developed themselves. Under these circumstances, the uncontrolled companies may be useful in determining a market return for the routine contributions of USC and EC, but that return would not reflect the value of the intangible property employed by USC and EC. Thus, none of the uncontrolled companies is sufficiently similar so that reliable results would be obtained using the resale price, cost plus, or comparable profits methods. Moreover, no uncontrolled companies can be identified that engaged in sufficiently similar activities and transactions with each other to employ the comparable profit split method.

(iv) Given the difficulties in applying the other methods, the reliability of the internal data on USC and EC, and the fact that acceptable comparables are available for deriving a market return for the routine contributions of USC and EC, the residual profit split method is likely to provide the most reliable measure of an arm's length result in this case.

Example 9. Comparable profits method preferred to profit split. (i) Company X is a large, complex U.S. company that carries out extensive research and development activities and manufactures and markets a variety of products. Company X has developed a new process by which compact disks can be fabricated at a fraction of the cost previously required. The process is expected to prove highly profitable, since there is a large market for compact disks. Company X establishes a new foreign subsidiary, Company Y, and licenses it the rights to use the process to fabricate compact disks for the foreign market as well as continuing technical support and improvements to the process. Company Y uses the process to fabricate compact disks which it supplies to related and unrelated parties.

(ii) The process licensed to Company Y is unique and highly valuable and no uncontrolled transfers of intangible property can be found that are sufficiently comparable to permit reliable application of the comparable uncontrolled transaction method. Company X is a large, complex company engaged in a variety of activities that owns unique and highly valuable intangible property. Consequently, no uncontrolled companies can be found that are similar to Company X. Furthermore, application of the profit split method in this case would involve the difficult and problematic tasks of allocating Company X's costs and assets between the relevant business activity and other activities and assigning a value to Company X's intangible contributions. On the other hand, Company Y performs relatively routine manufacturing and marketing activities and there are a number of similar uncontrolled companies. Thus, application of the comparable profits method using Company Y as the tested party is likely to produce a more reliable measure of an arm's length result than a profit split in this case.

[T.D. 8552, 59 FR 35028, July 8, 1994]

§ 1.483–1 Interest on certain deferred payments.

(a) *Amount constituting interest in certain deferred payment transactions*—(1) *In general.* Except as provided in paragraph (c) of this section, section 483 applies to a contract for the sale or exchange of property if the contract provides for one or more payments due more than 1 year after the date of the sale or exchange, and the contract does not provide for adequate stated interest. In general, a contract has adequate stated interest if the contract provides for a stated rate of interest that is at least equal to the test rate (determined under § 1.483–3) and the interest is paid or compounded at least annually. Section 483 may apply to a contract whether the contract is express (written or oral) or implied. For purposes of section 483, a sale or exchange is any transaction treated as a sale or exchange for tax purposes. In addition, for purposes of section 483, property includes debt instruments and investment units, but does not include money, services, or the right to use property. For the treatment of certain obligations given in exchange for services or the use of property, see sections 404 and 467. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See § 1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Treatment of contracts to which section 483 applies*—(i) *Treatment of unstated interest.* If section 483 applies to a contract, unstated interest under the contract is treated as interest for tax purposes. Thus, for example, unstated interest is not treated as part of the amount realized from the sale or exchange of property (in the case of the seller), and is not included in the purchaser's basis in the property acquired in the sale or exchange.

(ii) *Method of accounting for interest on contracts subject to section 483.* Any stated or unstated interest on a contract subject to section 483 is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). See §§ 1.446–1, 1.451–1, and 1.461–1. For purposes of the preceding sentence, the amount of interest (including unstated interest) allocable to a payment under a contract to which section 483 applies is determined under § 1.446–2(e).

(b) *Definitions*—(1) *Deferred payments.* For purposes of the regulations under section 483, a deferred payment means any payment that constitutes all or a part of the sales price (as defined in paragraph (b)(2) of this section), and that is due more than 6 months after the date of the sale or exchange. Except as provided in section 483(c)(2) (relating to the treatment of a debt instrument of the purchaser), a payment may be made in the form of cash, stock or securities, or other property.

(2) *Sales price.* For purposes of section 483, the sales price for any sale or exchange is the sum of the amount due under the contract (other than stated interest) and the amount of any liability included in the amount realized from the sale or exchange. See § 1.1001–2. Thus, the sales price for any sale or exchange includes any amount of unstated interest under the contract.

any interest, or amount treated as interest, on a contract subject to this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

(b) *Examples.* The following examples illustrate the provisions of paragraph (a) of this section:

Example 1. Deferred payment sale with contingent interest—(i) *Facts.* On December 31, 1996, A sells depreciable personal property to B. As consideration for the sale, B issues to A a debt instrument with a maturity date of December 31, 2001. The debt instrument provides for a principal payment of $200,000 on the maturity date, and a payment of interest on December 31 of each year, beginning in 1997, equal to a percentage of the total gross income derived from the property in that year. However, the total interest payable on the debt instrument over its entire term is limited to a maximum of $50,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually, and the mid-term applicable Federal rate is 5 percent, compounded annually.

(ii) *Treatment of noncontingent payment as separate contract.* Each payment of interest is a contingent payment. Accordingly, under paragraph (a) of this section, for purposes of applying section 483 to the debt instrument, the right to the noncontingent payment of $200,000 is treated as a separate contract. The amount of unstated interest on this separate contract is equal to $43,295, which is the amount by which the payment ($200,000) exceeds the present value of the payment ($156,705), calculated using the test rate of 5 percent, compounded annually. The $200,000 payment is thus treated as consisting of a payment of interest of $43,295 and a payment of principal of $156,705. The interest is includible in A's gross income, and deductible by B, under their respective methods of accounting.

(iii) *Treatment of contingent payments.* Assume that the amount of the contingent payment that is paid on December 31, 1997, is $20,000. Under paragraph (a) of this section, the $20,000 payment is treated as a payment of principal of $19,231 (the present value, as of the date of sale, of the $20,000 payment, calculated using a test rate equal to 4 percent, compounded annually) and a payment of interest of $769. The $769 interest payment is includible in A's gross income, and deductible by B, in their respective taxable years in which the payment occurs. The amount treated as principal gives B additional basis in the property on December 31, 1997. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 4 percent, compounded annually, for the payments made on December 31, 1998, and December 31, 1999, and a test rate of 5 percent, compounded annually, for the payments made on December 31, 2000, and December 31, 2001.

Example 2. Contingent stock payout—(i) *Facts.* M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1996, pursuant to a reorganization qualifying under section 368(a)(1)(B), M acquires the one-half interest of O held by N in exchange for 30,000 shares of M voting stock and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1997 or in 1998. In 1999, the annual earnings of O exceed the specified amount, and, on December 31, 1999, an additional 3,000 M voting shares are transferred to N. The fair market value of the 3,000 shares on December 31, 1999, is $300,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually. M and N are calendar year taxpayers.

(ii) *Allocation of interest.* Section 1274 does not apply to the right to receive the additional shares because the right is not a debt instrument for federal income tax purposes. As a result, the transfer of the 3,000 M voting shares to N is a deferred payment subject to section 483 and a portion of the shares is treated as unstated interest under that section. The amount of interest allocable to the shares is equal to the excess of $300,000 (the fair market value of the shares on December 31, 1999) over $266,699 (the present value of $300,000, determined by discounting the payment at the test rate of 4 percent, compounded annually, from December 31, 1999, to December 31, 1996). As a result, the amount of interest allocable to the payment of the shares is $33,301 ($300,000–$266,699). Both M and N take the interest into account in 1999.

(c) *Effective date.* This section applies to sales and exchanges that occur on or after August 13, 1996.

[T.D. 8674, 61 FR 30138, June 14, 1996]

REGULATIONS APPLICABLE FOR TAXABLE YEARS BEGINNING ON OR BEFORE APRIL 21, 1993

§ 1.482–1A Allocation of income and deductions among taxpayers.

(a) *Definitions.* When used in this section and in § 1.482–2—

(1) The term "organization" includes any organization of any kind, whether

it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as

would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See §1.482–2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U.S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the U.S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the U.S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U.S. income tax liability of such member for a later taxable year, or for the purposes of determining the U.S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

(i) The date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such adjustment,

(ii) Acceptance of a Form 870–AD (Offer of Waiver of Restriction on Assessment and Collection Deficiency in Tax and Acceptance of Overassessment),

(iii) Payment of the deficiency,

(iv) Stipulation in the Tax Court of the United States, or

(v) Final determination of tax liability by offer-in-compromise, closing agreement, or court action.

The principles of this subparagraph may be illustrated by the following examples in each of which it is assumed that X and Y are members of the same group of controlled entities and that they regularly compute their incomes on the basis of a calendar year:

Example (1). Assume that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length rental charge for Y's use of X's tangible property in 1966; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. The primary adjustment is therefore considered to have been made in 1968. Assume further that both X and Y are United States corporations and that Y had net operating losses in 1963, 1964, 1965, 1966, and 1967. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability for any pending taxable year, an adjustment increasing Y's net operating loss for 1966 shall be deemed to have been made for the purposes of determining Y's U.S. income tax liability for 1968 or a later taxable year to which the increased operating loss may be carried. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (2). Assume that X and Y are United States corporations; that X is in the business of rendering engineering services; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length fee for the rendition of engineering services by X in 1966 relating to the construction of Y's factory; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Assume further that fees for such services would properly constitute a capital expenditure by Y, and that Y does not place the factory in service until 1969. Although a correlative adjustment (increase in basis) would not have an effect on Y's U.S. income tax liability for a pending taxable year, an adjustment increasing the basis of Y's assets for 1966 shall be deemed to have been made in 1968 for the purpose of computing allowable depreciation or gain or loss on disposition for 1969 and any future taxable year. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (3). Assume that X is a U.S. taxpayer and Y is a foreign taxpayer not engaged in a trade or business in the United States; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length interest charge on a loan made to Y; that X consents to an assessment reflecting such allocation by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability, an adjustment in Y's income for 1966 shall be deemed to have been made in 1968 for the purposes of determining the amount of Y's earnings and profits for 1966 and subsequent years, and of any other effect it may have on any person's U.S. income tax liability for any taxable year. The district director shall notify X in writing of the amount and nature of the allocation which is deemed to have been made to Y.

(3) In making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director shall consider the effect upon such members of an arrangement between them for reimbursement within a reasonable period before or after the taxable year if the taxpayer can establish that such an arrangement in fact existed during the taxable year under consideration. The district director shall also consider the effect of any other nonarm's length transaction between them in the taxable year which, if taken into account, would result in a setoff against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. For purposes of the preceding sentence, the term arm's length refers to the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances considering all the relevant facts and without regard to the rules found in § 1.482–2 by which certain charges are deemed to be equal to arm's length. For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first

member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the first member as a result of the other activities will be set-off against the allocation which would otherwise be made. If the effect of the set-off is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the United States tax liability of any member, allocations will be made to reflect the correct amount of each category of income or deductions. In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later. The principles of this subparagraph may be illustrated by the following examples, in each of which it is assumed that P and S are calendar year corporations and are both members of the same group of controlled entities:

Example (1). P performs services in 1966 for the benefit of S in connection with S's manufacture and sale of a product. S does not pay P for such services in 1966, but in consideration for such services, agrees in 1966 to pay P a percentage of the amount of sales of the product in 1966 through 1970. In 1966 it appeared this agreement would provide adequate consideration for the services. No allocation will be made with respect to the services performed by P.

Example (2). P renders services to S in connection with the construction of S's factory. An arm's length charge for such services, determined under paragraph (b) of § 1.482–2, would be $100,000. During the same taxable year P makes available to S a machine to be used in such construction. P bills S $125,000 for the services, but does not bill for the use of the machine. No allocation will be made with respect to the excessive charge for services or the undercharge for the machine if P can establish that the excessive charge for services was equal to an arm's length charge for the use of the machine, and if the taxable income and income tax liabilities of P and S are not distorted.

Example (3). Assume the same facts as in example (2), except that, if P had reported $25,000 as rental income and $25,000 less service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in § 1.482–2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, if one member of a controlled group sells a product at less than an arm's length price to a second member of the group in one taxable year and the second member resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year. Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

(5) Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss. See, for example, "National Securities Corporation v. Commissioner of Internal

Revenue", 137 F. 2d 600 (3d Cir. 1943), cert. denied 320 U.S. 794 (1943).

(6) If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be treated as deferrable income or deductions, providing the taxpayer has, for the year to which the distributions, apportionments, or allocations relate, elected to use a method of accounting in which the reporting of deferrable income is deferred until the income ceases to be deferrable income. Under such method of accounting, referred to in this section as the deferred income method of accounting, any payments or reimbursements which were prevented or would have been prevented, and any deductions attributable directly or indirectly to such payments or reimbursements, shall be deferred until they cease to be deferrable under such method of accounting. If such method of accounting has not been elected with respect to the taxable year to which the allocations under section 482 relate, the taxpayer may elect such method with respect to such allocations (but not with respect to other deferrable income) at any time before the first occurring of the following events with respect to the allocations:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments reflecting such allocations or before July 16, 1968, whichever is later; or

(iii) Execution of a closing agreement or offer-in-compromise.

The principles of this subparagraph may be illustrated by the following example in which it is assumed that X, a domestic corporation, and Y, a foreign corporation, are members of the same group of controlled entities:

Example. X, which is in the business of rendering a certain type of service to unrelated parties, renders such services for the benefit of Y in 1965. The direct and indirect costs allocable to such services are $60,000, and an arm's length charge for such services is $100,000. Assume that the district director proposes to increase X's income by $100,000, but that the country in which Y is located would have blocked payment in 1965 for such services. If, prior to the first occurring of the events described in subdivisions (i), (ii), or (iii) of this subparagraph, X elects to use the deferred income method of accounting with respect to such allocation, the $100,000 allocation and the $60,000 of costs are deferrable until such amounts cease to be deferrable under X's method of accounting.

[T.D. 6595, 27 FR 3598, Apr. 14, 1962, as amended by T.D. 6952, 33 FR 5848, Apr. 16, 1968. Redesignated by T.D. 8470, 58 FR 5271, Jan. 21, 1993]

§ 1.482–2A Determination of taxable income in specific situations.

(a)–(c) For applicable rules, see § 1.482–2T (a) through (c).

(d) *Transfer or use of intangible property*—(1) *In general.* (i) Except as otherwise provided in subparagraph (4) of this paragraph, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use. Subparagraph (2) of this paragraph provides rules for determining the form an amount of an appropriate allocation, subparagraph (3) of this paragraph provides a definition of "intangible property", and subparagraph (4) of this paragraph provides rules with respect to certain cost-sharing arrangements in connection with the development of intangible property. For purposes of this paragraph, an interest in intangible property may take the form of the right to use such property.

Revenue", 137 F. 2d 600 (3d Cir. 1943), cert. denied 320 U.S. 794 (1943).

(6) If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be treated as deferrable income or deductions, providing the taxpayer has, for the year to which the distributions, apportionments, or allocations relate, elected to use a method of accounting in which the reporting of deferrable income is deferred until the income ceases to be deferrable income. Under such method of accounting, referred to in this section as the deferred income method of accounting, any payments or reimbursements which were prevented or would have been prevented, and any deductions attributable directly or indirectly to such payments or reimbursements, shall be deferred until they cease to be deferrable under such method of accounting. If such method of accounting has not been elected with respect to the taxable year to which the allocations under section 482 relate, the taxpayer may elect such method with respect to such allocations (but not with respect to other deferrable income) at any time before the first occurring of the following events with respect to the allocations:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments reflecting such allocations or before July 16, 1968, whichever is later; or

(iii) Execution of a closing agreement or offer-in-compromise.

The principles of this subparagraph may be illustrated by the following example in which it is assumed that X, a domestic corporation, and Y, a foreign corporation, are members of the same group of controlled entities:

Example. X, which is in the business of rendering a certain type of service to unrelated parties, renders such services for the benefit of Y in 1965. The direct and indirect costs allocable to such services are $60,000, and an arm's length charge for such services is $100,000. Assume that the district director proposes to increase X's income by $100,000, but that the country in which Y is located would have blocked payment in 1965 for such services. If, prior to the first occurring of the events described in subdivisions (i), (ii), or (iii) of this subparagraph, X elects to use the deferred income method of accounting with respect to such allocation, the $100,000 allocation and the $60,000 of costs are deferrable until such amounts cease to be deferrable under X's method of accounting.

[T.D. 6595, 27 FR 3598, Apr. 14, 1962, as amended by T.D. 6952, 33 FR 5848, Apr. 16, 1968. Redesignated by T.D. 8470, 58 FR 5271, Jan. 21, 1993]

§ 1.482–2A Determination of taxable income in specific situations.

(a)–(c) For applicable rules, see § 1.482–2T (a) through (c).

(d) *Transfer or use of intangible property*—(1) *In general.* (i) Except as otherwise provided in subparagraph (4) of this paragraph, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use. Subparagraph (2) of this paragraph provides rules for determining the form an amount of an appropriate allocation, subparagraph (3) of this paragraph provides a definition of "intangible property", and subparagraph (4) of this paragraph provides rules with respect to certain cost-sharing arrangements in connection with the development of intangible property. For purposes of this paragraph, an interest in intangible property may take the form of the right to use such property.

(ii)*(a)* In the absence of a bona fide cost-sharing arrangement (as defined in subparagraph (4) of this paragraph), where one member of a group of related entities undertakes the development of intangible property as a developer within the meaning of *(c)* of this subdivision, no allocation with respect to such development activity shall be made under the rules of this paragraph or any other paragraph of this section (except as provided in *(b)* of this subdivision) until such time as any property developed, or any interest therein, is or is deemed to be transferred, sold, assigned, loaned, or otherwise made available in any manner by the developer to a related entity in a transfer subject to the rules of this paragraph. Where a member of the group other than the developer acquires an interest in the property developed by virtue of obtaining a patent or copyright, or by any other means, the developer shall be deemed to have transferred such interest in such property to the acquiring member in a transaction subject to the rules of this paragraph. For example, if one member of a group (the developer) undertakes to develop a new patentable product and the costs of development are incurred by that entity over a period of 3 years, no allocation with respect to that entity's activity shall be made during such period. The amount of any allocation that may be appropriate at the expiration of such development period when, for example, the patent on the product is transferred, or deemed transferred, to a related entity for other than an arm's length consideration, shall be determined in accordance with the rules of this paragraph.

(b) Where one member of a group renders assistance in the form of loans, services, or the use of tangible or intangible property to a developer in connection with an attempt to develop intangible property, the amount of any allocation that may be appropriate with respect to such assistance shall be determined in accordance with the rules of the appropriate paragraph or paragraphs of this section. Thus, where one entity allows a related entity, which is the developer, to use tangible property, such as laboratory equipment, in connection with the development of intangible property, the amount of any allocation that may be appropriate with respect to such use shall be determined in accordance with the rules of paragraph *(c)* of this section. In the event that the district director does not exercise his discretion to make allocations with respect to the assistance rendered to the developer, the value of the assistance shall be allowed as a set-off against any allocation that the district director may make under this paragraph as a result of the transfer of the intangible property to the entity rendering the assistance.

(c) The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all the facts and circumstances of the individual case. Of all the facts and circumstances to be taken into account in making this determination, greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group, and the relative values of the use of any intangible property of members of the group which is made available without adequate consideration for use in connection with the development activity, which property is likely to contribute to a substantial extent in the production of intangible property. For this purpose, the risk to be borne with respect to development activity is the possibility that such activity will not result in the production of intangible property or that the intangible property produced will not be of sufficient value to allow for the recovery of the costs of developing it. A member will not be considered to have borne the costs and corresponding risks of development unless such member is committed to bearing such costs in advance of, or contemporaneously with, their incurrence and without regard to the success of the project. Other factors that may be relevant in determining which member of the group is the developer include the location of the development activity, the capabilities of the various members to carry on

the project independently, and the degree of control over the project exercised by the various members.

(d) The principles of this subdivision (ii) may be illustrated by the following examples in which it is assumed that X and Y are corporate members of the same group:

Example (1). X, at the request of Y, undertakes to develop a new machine which will function effectively in the climate in which Y's factory is located. Y agrees to bear all the direct and indirect costs of the project whether or not X successfully develops the machine. Assume that X does not make any of its own intangible property available for use in connection with the project. The machine is successfully developed and Y obtains possession of the intangible property necessary to produce such machine. Based on the facts and circumstances as stated, Y shall be considered to be the developer of the intangible property and, therefore, Y shall not be treated as having obtained the property in a transfer subject to the rules of this paragraph. Any amount which may be allocable with respect to the assistance rendered by X shall be determined in accordance with the rules of *(b)* of this subdivision.

Example (2). Assume the same facts as in example (1) except that Y agrees to reimburse X for its costs only in the event that the property is successfully developed. In such case X is the developer and Y is deemed to have received the property in a transfer subject to the rules of this paragraph. Therefore, the district director may make an allocation to reflect an arm's length consideration for such property.

Example (3). In 1967 X undertakes to develop product M in its research and development department. X incurs direct and indirect costs of $1 million per year in connection with the project in 1967, 1968, and 1969. In connection with the project, X employs the formula for compound N, which it owns, and which is likely to contribute substantially to the success of the project. The value of the use of the formula for compound N in connection with this project is $750,000. In 1968, 4 chemists employed by Y spend 6 months working on the project in X's laboratory. The salary and other expenses connected with the chemists' employment for that period ($100,000) are paid by Y, for which no charge is made to X. In 1969, product M is perfected and Y obtains patents thereon. X is considered to be the developer of product M since, among other things, it bore the greatest relative share of the costs and risks incurred in connection with this project and made available intangible property (formula for compound N) which was likely to contribute substantially in the development of product M. Accordingly, no allocation with respect to X's development activity should be made before 1969. The property is deemed to have been transferred to Y at that time by virtue of the fact that Y obtained the patent rights to product M. In such case the district director may make an allocation to reflect an arm's length consideration for such transfer. In the event that the district director makes such an allocation and he has not made or does not make an allocation for 1968 with respect to the services of the chemists in accordance with the principles of paragraph (b) of this section, the value of the assistance shall be allowed as a set-off against the amount of the allocation reflecting an arm's length consideration for the transfer of the intangible property.

(2) *Arm's length consideration.* (i) An arm's length consideration shall be in a form which is consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms:

(a) Royalties based on the transferee's output, sales, profits, or any other measure;

(b) Lump-sum payments; or

(c) Any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them.

However, where the transferee pays nominal or no consideration for the property or interest therein and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.

(ii) In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration.

(iii) Where a sufficiently similar transaction involving an unrelated party cannot be found, the following factors, to the extent appropriate (depending upon the type of intangible property and the form of the transfer), may be considered in arriving at the amount of the arm's length consideration:

(a) The prevailing rates in the same industry or for similar property,

(b) The offers of competing transferors or the bids of competing transferees,

(c) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted,

(d) The uniqueness of the property and the period for which it is likely to remain unique,

(e) The degree and duration of protection afforded to the property under the laws of the relevant countries.

(f) Value of services rendered by the transferor to the transferee in connection with the transfer within the meaning of paragraph (b)(8) of this section,

(g) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,

(h) The capital investment and starting up expenses required of the transferee,

(i) The next subdivision is *(j)*,

(j) The availability of substitutes for the property transferred,

(k) The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,

(l) The costs incurred by the transferor in developing the property, and

(m) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

(3) *Definition of intangible property.* (i) Solely for the purposes of this section, intangible property shall consist of the items described in subdivision (ii) of this subparagraph, provided that such items have substantial value independent of the services of individual persons.

(ii) The items referred to in subdivision (i) of this subparagraph are as follows:

(a) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(b) Copyrights, literary, musical, or artistic compositions, and other similar items;

(c) Trademarks, trade names, brand names, and other similar items;

(d) Franchises, licenses, contracts, and other similar items;

(e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

(4) *Sharing of costs and risks.* Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risk to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such an arrangement. If an oral cost sharing arrangement, entered into prior to April 16, 1968, and continued in effect after that date, is otherwise in compliance with the standards prescribed in this subparagraph, it shall constitute a bona fide cost sharing arrangement if it is

reduced to writing prior to January 1, 1969.

(e) *Sales of tangible property*—(1) *In general.* (i) Where one member of a group of controlled entities (referred to in this paragraph as the "seller") sells or otherwise disposes of tangible property to another member of such group (referred to in this paragraph as the "buyer") at other than an arm's length price (such a sale being referred to in this paragraph as a "controlled sale"), the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

(ii) Subparagraphs (2), (3), and (4) of this paragraph describe three methods of determining an arm's-length price and the standards for applying each method. They are, respectively, the comparable uncontrolled price method, the resale price method, and the cost-plus method. In addition, a special rule is provided in subdivision (v) of this subparagraph for use (notwithstanding any other provision of this subdivision) in determining an arm's-length price for an ore or mineral. If there are comparable uncontrolled sales as defined in subparagraph (2) of this paragraph, the comparable uncontrolled price method must be utilized because it is the method likely to result in the most accurate estimate of an arm's-length price (for the reason that it is based upon the price actually paid by unrelated parties for the same or similar products). If there are no comparable uncontrolled sales, then the resale price method must be utilized if the standards for its application are met because it is the method likely to result in the next most accurate estimate in such instances (for the reason that, in such instances, the arm's-length price determined under such method is based more directly upon actual arm's-length transactions than is the cost-plus method). A typical situation where the resale price method may be required is where a manufacturer sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions. If all the standards for the mandatory application of the resale price method are not satisfied, then, as provided in subparagraph (3)(iii) of this paragraph, either that method or the cost-plus method may be used, depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's-length price. A typical situation where the cost-plus method may be appropriate is where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by reason of its utilization of its intangible property prior to resale in uncontrolled transactions.

(iii) Where the standards for applying one of the three methods of pricing described in subdivision (ii) of this subparagraph are met, such method must, for the purposes of this paragraph, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate. Where none of the three methods of pricing described in subdivision (ii) of this subparagraph can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.

(iv) The methods of determining arm's length prices described in this section are stated in terms of their application to individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the district director may determine or verify the arm's length price of all sales to a related entity by employing reasonable statistical sampling techniques.

(v) The price for a mineral product which is sold at the stage at which mining or extraction ends shall be determined under the provisions of §§ 1.613–3 and 1.613–4.

(2) *Comparable uncontrolled price method.* (i) Under the method of pricing described as the "comparable uncontrolled price method", the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales, adjusted as provided in subdivision (ii) of this subparagraph.

(ii) "Uncontrolled sales" are sales in which the seller and the buyer are not members of the same controlled group. These include *(a)* sales made by a member of the controlled group to an unrelated party, *(b)* sales made to a member of the controlled group by an unrelated party, and *(c)* sales made in which the parties are not members of the controlled group and are not related to each other. However, uncontrolled sales do not include sales at unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a nonarm's length price on a large volume of controlled sales. Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved. The principles of this subdivision may be illustrated by the following examples, in each of which it is assumed that X makes both controlled and uncontrolled sales of the identical property:

Example (1). Assume that the circumstances surrounding the controlled and the uncontrolled sales are identical, except for the fact that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. X's factory. Since differences in terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

Example (2). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X affixes its valuable trademark in the controlled sales, and does not affix its trademark in uncontrolled sales. Since the effects on price of differences in intangible property associated with the sale of tangible property, such as trademarks, are normally not reasonably ascertainable, such differences would normally render the uncontrolled sales noncomparable.

Example (3). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X, a manufacturer of business machines, makes certain minor modifications in the physical properties of the machines to satisfy safety specifications or other specific requirements of a customer in controlled sales, and does not make these modifications in uncontrolled sales. Since minor physical differences in the product generally have a definite and reasonably ascertainable effect on prices, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

(iii) Where there are two or more comparable uncontrolled sales susceptible of adjustment as defined in subdivision (ii) of this subparagraph, the comparable uncontrolled sale or sales requiring the fewest and simplest adjustments provided in subdivision (ii) of this subparagraph should generally be selected. Thus, for example, if a taxpayer makes comparable uncontrolled sales of a particular product which differ from the controlled sale only with respect to the terms of delivery, and makes other comparable uncontrolled sales of the product which differ from the controlled sale with respect to both terms of delivery and terms of payment, the comparable uncontrolled sales differing only with respect to terms of delivery should be selected as the comparable uncontrolled sale.

(iv) One of the circumstances which may affect the price of property is the fact that the seller may desire to make sales at less than a normal profit for the primary purpose of establishing or maintaining a market for his products. Thus, a seller may be willing to reduce the price of a product, for a time, in order to introduce his product into an area or in order to meet competition. However, controlled sales may be priced in such a manner only if such price would have been charged in an uncontrolled sale under comparable circumstances. Such fact may be demonstrated by showing that the buyer in the controlled sale made corresponding reductions in the resale price to uncontrolled purchasers, or that such buyer engaged in substantially greater sales promotion activities with respect to the product involved in the controlled sale than with respect to other products. For example, assume X, a manufacturer of batteries, commences to sell car batteries to Y, a subsidiary of X, for resale in a new market. In its existing markets X's batteries sell to independent retailers at $20 per unit, and X sells them to wholesalers at $17 per unit. Y also sells X's batteries to independent retailers at $20 per unit. X's batteries are not known in the new market in which Y is operating. In order to engage competitively in the new market Y incurs selling and advertising costs substantially higher than those incurred for its sales of other products. Under these circumstances X may sell to Y, for a time, at less than $17 to take into account the increased selling and advertising activities of Y in penetrating and establishing the new market. This may be done even though it may result in a transfer price from X to Y which is below X's full costs of manufacturing the product.

(3) *Resale price method.* (i) Under the pricing method described as the "resale price method", the arm's length price of a controlled sale is equal to the applicable resale price (as defined in subdivision (iv) or (v) of this subparagraph), reduced by an appropriate markup, and adjusted as provided in subdivision (ix) of this subparagraph. An appropriate markup is computed by multiplying the applicable resale price by the appropriate markup percentage as defined in subdivision (vi) of this subparagraph. Thus, where one member of a group of controlled entities sells property to another member which resells the property in uncontrolled sales, if the applicable resale price of the property involved in the uncontrolled sale is $100 and the appropriate markup percentage for resales by the buyer is 20 percent, the arm's length price of the controlled sale is $80 ($100 minus 20 percent × $100), adjusted as provided in subdivision (ix) of this subparagraph.

(ii) The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

(a) There are no comparable uncontrolled sales as defined in subparagraph (2) of this paragraph.

(b) An applicable resale price, as defined in subdivision (iv) or (v) of this subparagraph, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.

(c) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration.

(d) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property. See § 1.482–2(d)(3) for the definition of intangible property.

(iii) Notwithstanding the fact that one or both of the requirements of subdivision (ii) *(c)* or *(d)* of this subparagraph may not be met, the resale price method may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method. Thus, even though one of the requirements of such subdivision is not satisfied, the resale price method may nevertheless be more appropriate than the cost plus method because the computations and evaluations required under the former method may be fewer and easier to make than under the latter method. In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller). The principle of this subdivision may be illustrated by the following examples in each of which it is assumed that corporation X developed a valuable patent covering product M which it manufactures and sells to corporation Y in a controlled sale, and for which there is no comparable uncontrolled sale:

Example (1). Corporation Y adds a component to product M and resells the assembled product in an uncontrolled sale within a reasonable time after the controlled sale of product M. Assume further that the addition of the component added more than an insubstantial amount to the value of product M, but that Y's function in purchasing the component and assembling the product prior to sale was subject to reasonably precise valuation. Although the controlled sale and resale does not meet the requirements of subdivision (ii)*(c)* of this subparagraph, the resale price method may be used under the circumstances because that method involves computations and evaluations which are fewer and easier to make than under the cost plus method. This is because X's use of a patent may be more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of Y's assembling function in determining the appropriate markup percentage under the resale price method.

Example (2). Corporation Y resells product M in an uncontrolled sale within a reasonable time after the controlled sale after attaching its valuable trademark to it. Assume further that it can be demonstrated through comparison with other uncontrolled sales of Y that the addition of Y's trademark to a product usually adds 25 percent to the markup on its sales. On the other hand, the effect of X's use of its patent is difficult to evaluate in applying the cost plus method because no reasonable standard of comparison is available. Although the controlled sale and resale does not meet the requirements of subdivision (ii)*(d)* of this subparagraph, the resale price method may be used because that method involves computations and evaluation which are fewer and easier to make than under the cost plus method. That is because, under the circumstances, X's use of a patent is more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of the use of Y's trademark in determining the appropriate markup percentage under the resale price method.

(iv) For the purposes of this subparagraph the "applicable resale price" is the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an uncontrolled sale. The "applicable resale price" will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved.

(v) Where the property purchased in the controlled sale is resold in another controlled sale, the "applicable resale price" is the price at which such property is finally resold in an uncontrolled sale, providing that the series of sales as a whole meets all the requirements of subdivision (ii) of this subparagraph or that the resale price method is used pursuant to subdivision (iii) of this subparagraph. In such case, the determination of the appropriate markup percentage shall take into account the function or functions performed by all members of the group participating in the series of sales and resales. Thus, if X sells a product to Y in a controlled sale, Y sells the product to Z in a controlled sale, and Z sells the product in an uncontrolled sale, the resale price method must be used if Y and Z together have not added more than an insubstantial amount to the value of the product through physical alteration or the application of intangible property, and the final resale occurs within a reasonable time of the sale from X to Y. In such case, the applicable resale price is the price at which Z sells the product in the uncontrolled sale, and the appropriate markup percentage shall take into account the functions performed by both Y and Z.

(vi) For the purposes of this subparagraph, the appropriate markup percentage is equal to the percentage of gross profit (expressed as a percentage of sales) earned by the buyer (reseller) or another party on the resale of property which is both purchased and resold in an uncontrolled transaction, which resale is most similar to the applicable resale of the property involved in the controlled sale. The following are the most important characteristics to be considered in determining the similarity of resales:

(a) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(b) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor assembly, advertising, selling at wholesale, selling at retail, billing, maintenance of accounts receivable, and servicing.

(c) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the reseller.

In general, the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and resales on the one hand and the controlled purchases and resales on the other hand. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.

(vii) Whenever possible, markup percentages should be derived from uncontrolled purchases and resales of the buyer (reseller) involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of resales by the same buyer (reseller) which meet the standards of subdivision (vi) of this subparagraph, evidence of an appropriate markup percentage may be derived from resales by other resellers selling in the same or a similar market in which the controlled buyer (reseller) is selling providing such resellers perform comparable functions. Where the function performed by the reseller is similar to the function performed by a sales agent which does not take title, such sales agent will be considered a reseller for the purpose of determining an appropriate markup percentage under this subparagraph and the commission earned by such sales agent, expressed as a percentage of the sales price of the goods, may constitute the appropriate markup percentage. If the controlled buyer (reseller) is located in a foreign country and information on resales by other resellers in the same foreign market is not available, then markup percentages earned by United States resellers performing comparable functions may be used. In the absence of data on markup percentages of particular sales or groups of sales, the prevailing markup percentage in the particular industry involved may be appropriate.

(viii) In calculating the markup percentage earned on uncontrolled purchases and resales, and in applying such percentage to the applicable resale price to determine the appropriate markup, the same elements which enter into the computation of the sales price and the costs of goods sold of the property involved in the comparable uncontrolled purchases and resales should enter into such computation in the case of the property involved in the controlled purchases and resales. Thus, if freight-in and packaging expense are elements of the cost of goods sold in comparable uncontrolled purchases, then such elements should also be taken into account in computing the cost of goods sold of the controlled purchase. Similarly, if the comparable markup percentage is based upon net sales (after reduction for returns and allowances) of uncontrolled resellers, such percentage must be applied to net sales of the buyer (reseller).

(ix) In determining an arm's length price appropriate adjustment must be made to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price. The principles of this subdivision may be illustrated by the following example:

Example. Assume that X and Y are members of the same group of controlled entities and that Y purchases electric mixers from X and electric toasters from uncontrolled entities. Y performs substantially similar functions with respect to resales of both the mixers and the toasters, except that it does not warrant the toasters, but does provide a 90-day warranty for the mixers. Y normally earns a gross profit on toasters of 20 percent of gross selling price. The 20-percent gross profit on the resale of toasters is an appropriate markup percentage, but the price of the controlled sale computed with reference to such rate must be adjusted to reflect the difference in terms (the warranty).

(4) *Cost plus method.* (i) Under the pricing method described as the "cost plus method", the arm's length price of a controlled sale of property shall be computed by adding to the cost of producing such property (as computed in subdivision (ii) of this subparagraph), an amount which is equal to such cost multiplied by the appropriate gross profit percentage (as computed in subdivision (iii) of this subparagraph), plus or minus any adjustments as provided in subdivision (v) of this subparagraph.

(ii) For the purposes of this subparagraph, the cost of producing the property involved in the controlled sale, and the costs which enter into the computation of the appropriate gross profit percentage shall be computed in a consistent manner in accordance with sound accounting practices for allocating or apportioning costs, which neither favors nor burdens controlled sales in comparison with uncontrolled sales. Thus, if the costs used in computing the appropriate gross profit percentage are comprised of the full cost of goods sold, including direct and indirect costs, then the cost of producing the property involved in the controlled sales must be comprised of the full cost of goods sold, including direct and indirect costs. On the other hand, if the costs used in computing the appropriate gross profit percentage are comprised only of direct costs, the cost of producing the property involved in the controlled sale must be comprised only of direct costs. The term "cost of producing", as used in this subparagraph, includes the cost of acquiring property which is held for resale.

(iii) For the purposes of this subparagraph, the appropriate gross profit percentage is equal to the gross profit percentage (expressed as a percentage of cost) earned by the seller or another party on the uncontrolled sale or sales of property which are most similar to the controlled sale in question. The following are the most important characteristics to be considered in determining the similarity of the uncontrolled sale or sales:

(a) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(b) The functions performed by the seller with respect to the property sold. For example: contract manufacturing, product assembly, selling activity, processing, servicing, delivering.

(c) The effect of any intangible property used by the seller in connection with the property sold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the seller. In general, the similarity to be sought relates to the probable effect upon the margin of gross profit of any differences in such characteristics between the uncontrolled sales and the controlled sale. Thus, close physical similarity of the property involved in the sales compared is not required under the cost plus method since a lack of close physical similarity is not necessarily indicative of dissimilar profit margins. See subparagraph (2)(iv) of this paragraph, relating to sales made at less than a normal profit for the primary purpose of establishing or maintaining a market.

(iv) Whenever possible, gross profit percentages should be derived from uncontrolled sales made by the seller involved in the controlled sale, because similar characteristics are more likely to be found among sales of property made by the same seller than among sales made by other sellers. In the absence of such sales, evidence of an appropriate gross profit percentage may be derived from similar uncontrolled sales by other sellers whether or not such sellers are members of the controlled group. Where the function performed by the seller is similar to the function performed by a purchasing agent which does not take title, such purchasing agent will be considered a seller for the purpose of determining an appropriate gross profit percentage under this subparagraph and the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may constitute the appropriate gross profit percentage. In the absence of data on gross profit percentages of particular sales or groups of sales which are similar to the controlled sale, the prevailing gross profit percentages in the particular industry involved may be appropriate.

(v) Where the most similar sale or sales from which the appropriate gross profit percentage is derived differ in any material respect from the controlled sale, the arm's length price which is computed by applying such percentage must be adjusted to reflect such differences to the extent such differences would warrant an adjustment of price in uncontrolled transactions. The differences referred to in this subdivision are those differences which have a definite and reasonably ascertainable effect on price.

(Sec. 385 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 613 and 68A Stat. 917; 26 U.S.C. 385 and 7805))

[T.D. 6952, 33 FR 5849, Apr. 16, 1968]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.482–2A, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.