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applies to taxable years beginning on or after January 1, 1995.

(j) Section 1.475(c)-2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. By its terms, however, § 1.475(c)-2(a)(3) applies only to residual interests or to interests or arrangements that are acquired on or after January 4, 1995; and the integrated transactions that are referred to in §§ 1.475(c)-2(a)(2) and 1.475(c)-2(b) exist only after August 13, 1996 (the effective date of § 1.1275-6).

(k) Section 1.475(d)-1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993.

[T.D. 8700, 61 FR 67725, Dec. 24, 1996. Redesignated and amended by T.D. 9328, 72 FR 32181, June 12, 2007; T.D. 9849, 84 FR 9235, Mar. 14, 2019]

ADJUSTMENTS**§ 1.481-1 Adjustments in general.**

(a)(1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and paragraph (e) of § 1.446-1. In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The "year of the change" is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

(2) Unless the adjustments are attributable to a change in method of accounting initiated by the taxpayer, no part of the adjustments required by subparagraph (1) of this paragraph

shall be based on amounts which were taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954 (hereinafter referred to as pre-1954 years).

(b) The adjustments specified in section 481(a) and this section shall take into account inventories, accounts receivable, accounts payable, and any other item determined to be necessary in order to prevent amounts from being duplicated or omitted.

(c)(1) The term "adjustments", as used in section 481, has reference to the net amount of the adjustments required by section 481(a) and paragraph (b) of this section. In the case of a change in the over-all method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term "net amount of the adjustments" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting. With respect to the portion of the adjustments attributable to pre-1954 years, it is immaterial that the same items or class of items with respect to which adjustments would have to be made (for the first taxable year to which section 481 applies) do not exist at the time the actual change in method of accounting occurs. For purposes of section 481, only the net dollar balance is to be taken into account. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(2) If a change in method of accounting is voluntary (i.e., initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§ 1.446-1(e)(3) and 1.481-4 which provide

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that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account.

(3) If the change in method of accounting is involuntary (i.e., not initiated by the taxpayer), then only the amount of the adjustments required by section 481(a) that is attributable to taxable years beginning after December 31, 1953, and ending after August 16, 1954, (hereinafter referred to as post-1953 years) is taken into account. This amount is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§ 1.446-1(e)(3) and 1.481-4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account. See also § 1.481-3 for rules relating to adjustments attributable to pre-1954 years.

(4) For any adjustments attributable to post-1953 years that are taken into account entirely in the year of change and that increase taxable income by more than \$3,000, the limitations on tax provided in section 481(b) (1) or (2) apply. See § 1.481-2 for rules relating to the limitations on tax provided by sections 481(b) (1) and (2).

(5) A change in the method of accounting initiated by the taxpayer includes not only a change which he originates by securing the consent of the Commissioner, but also a change from one method of accounting to another made without the advance approval of the Commissioner. A change in the taxpayer's method of accounting required as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer. On the other hand, a taxpayer who, on his own initiative, changes his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to have made an involuntary change.

(d) Any adjustments required under section 481(a) that are taken into account during a taxable year must be properly taken into account for purposes of computing gross income, adjusted gross income, or taxable income

in determining the amount of any item of gain, loss, deduction, or credit that depends on gross income, adjusted gross income, or taxable income.

[T.D. 6500, 25 FR 11731, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40078, Aug. 7, 1995]

§ 1.481-2 Limitation on tax.

(a) *Three-year allocation.* Section 481(b)(1) provides a limitation on the tax under chapter 1 of the Internal Revenue Code for the taxable year of change that is attributable to the adjustments required under section 481(a) and § 1.481-1 if the entire amount of the adjustments is taken into account in the year of change. If such adjustments increase the taxpayer's taxable income for the taxable year of the change by more than \$3,000, then the tax for such taxable year that is attributable to the adjustments shall not exceed the lesser of the tax attributable to taking such adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481-1, or the aggregate of the increases in tax that would result if the adjustments were included ratably in the taxable year of the change and the two preceding taxable years. For the purpose of computing the limitation on tax under section 481(b)(1), the adjustments shall be allocated ratably to the taxable year of the change and the two preceding taxable years, whether or not the adjustments are in fact attributable in whole or in part to such years. The limitation on the tax provided in this paragraph shall be applicable only if the taxpayer used the method of accounting from which the change was made in computing taxable income for the two taxable years preceding the taxable year of the change.

(b) *Allocation under new method of accounting.* Section 481(b)(2) provides a second alternative limitation on the tax for the taxable year of change under chapter 1 of the Internal Revenue Code that is attributable to the adjustments required under section 481(a) and § 1.481-1 where such adjustments increase taxable income for the taxable year of change by more than \$3,000. If the taxpayer establishes from his books of account and other records what his taxable income would have

been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of the change, and if the taxpayer in computing taxable income for such years used the method of accounting from which the change was made, then the tax attributable to the adjustments shall not exceed the smallest of the following amounts:

(1) The tax attributable to taking the adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481-1;

(2) The tax attributable to such adjustments computed under the 3-year allocation provided in section 481(b)(1), if applicable; or

(3) The net increase in the taxes under chapter 1 (or under corresponding provisions of prior revenue laws) which would result from allocating that portion of the adjustments to the one or more consecutive preceding taxable years to which properly allocable under the new method of accounting and from allocating the balance thereof to the taxable year of the change.

(c) *Rules for computation of tax.* (1) The first step in determining whether either of the limitations described in section 481(b) (1) or (2) applies is to compute the increase in tax for the taxable year of the change that is attributable to the increase in taxable income for such year resulting solely from the adjustments required under section 481(a) and § 1.481-1. This increase in tax is the excess of the tax for the taxable year computed by taking into account such adjustments under section 481(a) over the tax computed for such year without taking the adjustments into account.

(2) The next step is to compute under section 481(b)(1) the tax attributable to the adjustments referred to in paragraph (c)(1) of this section for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustments had been received or accrued in each of such taxable years. The increase in tax attributable to the adjustments for each such taxable year is the excess of the tax for such year computed with the al-

location of one-third of the net adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year. For the purpose of computing the aggregate increase in taxes for such taxable years, there shall be taken into account the increase or decrease in tax for any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(1) but which is affected by a net operating loss under section 172 or by a capital loss carryback or carryover under section 1212, determined with reference to taxable years with respect to which adjustments under section 481(b)(1) are allocated.

(3) In the event that the taxpayer satisfies the conditions set forth in section 481(b)(2), the next step is to determine the amount of the net increase in tax attributable to the adjustments referred to in paragraph (c)(1) of this section for:

(i) The taxable year of the change,

(ii) The consecutive taxable year or years immediately preceding the taxable year of the change for which the taxpayer can establish his taxable income under the new method of accounting, and

(iii) Any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(2), but which is affected by a net operating loss or by a capital loss carryback or carryover determined with reference to taxable years with respect to which such adjustments are allocated.

The net increase in tax for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph shall be computed as if the amount of the adjustments for the prior taxable years to which properly allocable in accordance with section 481(b)(2) had been received or accrued, or paid or incurred, as the case may be, in such prior years and the balance of the adjustments in the taxable year of the change. The amount of tax attributable to such adjustments for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph is the aggregate of the differences (increases and decreases) between the tax for each such year computed by taking into account

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the allocable portion of the adjustments in computing taxable income and the tax computed without taking into account any portion of the adjustments in computing taxable income. Generally, where there is an increase in taxable income for a preceding consecutive taxable year established under the new method of accounting, computed without regard to adjustments attributable to any preceding taxable year, the amount of the adjustments to be allocated to each such year shall be an amount equal to such increase. However, where the amount of the adjustments to be allocated to a prior taxable year is less than the increase in taxable income for such year established under the new method of accounting, the amount of the increase in such taxable income for purposes of determining the increase in tax under section 481(b)(2) for such year shall be considered to be the amount so allocated. For example, if the amount of the adjustments required by section 481(a) for 1958 (the taxable year of the change) is \$60,000, and the increase in taxable income is determined by the taxpayer to be \$40,000, \$5,000, and \$35,000, computed under the new method of accounting, for the taxable years 1957, 1956, and 1955, respectively, then the amount of the adjustments to be allocated to 1955 will be the balance of the adjustments, or \$15,000.

(4) The tax for the taxable year of the change shall be the tax for such year, computed without taking any of the adjustments referred to in paragraph (c)(1) of this section into account, increased by the smallest of the following amounts—

(i) The amount of tax for the taxable year of the change attributable solely to taking into account the entire amount of the adjustments required by section 481(a) and § 1.481-1;

(ii) The sum of the increases in tax liability for the taxable year of the change and the two immediately preceding taxable years that would have resulted solely from taking into account one-third of the amount of such adjustments required for each of such years as though such amounts had been properly attributable to such years (computed in accordance with paragraph (c)(2) of this section); or

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(iii) The net increase in tax attributable to allocating such adjustments under the new method of accounting (computed in accordance with paragraph (c)(3) of this section).

(5)(i) In the case of a change in method of accounting by a partnership, the adjustments required by section 481 shall be made with respect to the taxable income of the partnership but the limitations on tax under section 481(b) shall apply to the individual partners. Each partner shall take into account his distributive share of the partnership items, as so adjusted, for the taxable year of the change. Section 481(b) applies to a partner whose taxable income is so increased by more than \$3,000 as a result of such adjustments to the partnership taxable income. It is not necessary for the partner to have been a member of the partnership for the two taxable years immediately preceding the taxable year of the change of the partnership's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a partner may apply section 481(b)(2) even though he was not a member of the partnership for all the taxable years affected by the computation thereunder.

(ii) In the case of a change in method of accounting by an electing small business corporation under subchapter S, chapter 1 of the Code, the adjustments required by section 481 shall be made with respect to the taxable income of such electing corporation in the year of the change, but the limitations on tax under section 481(b) shall apply to the individual shareholders. Section 481(b) applies to a shareholder of an electing small business corporation whose taxable income is so increased by more than \$3,000 as a result of such adjustments to such corporation's taxable income. It is not necessary for the shareholder to have been a member of the electing small business corporation, or for such corporation to have been an electing small business corporation, for the two taxable years immediately preceding the taxable year of the change of the corporation's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a shareholder may apply section 481(b)(2), even

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though he was not a shareholder, or the corporation was not an electing small business corporation, for all the taxable years affected by the computation thereunder.

(6) For the purpose of the successive computations of the limitations on tax under section 481(b) (1) or (2), if the treatment of any item under the provisions of the Internal Revenue Code of 1986 (or corresponding provisions of prior internal revenue laws) depends upon the amount of gross income, adjusted gross income, or taxable income (for example, medical expenses, charitable contributions, or credits against the tax), such item shall be determined for the purpose of each such computation by taking into account the proper portion of the amount of any adjustments required to be taken into account under section 481 in each such computation.

(7) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning section 1314(a) for such year.

(8) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to tax on self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) *Examples.* The application of section 481(b) (1) and (2) may be illustrated by the following examples. Although the examples in this paragraph are based upon adjustments required in the case of a change in the over-all method of accounting, the principles illustrated would be equally applicable to adjustments required in the case of a change in method of accounting for a particular material item, provided the treatment of such adjustments is not specifically subject to some other provision of the Internal Revenue Code of 1986.

Example 1. An unmarried individual taxpayer using the cash receipts and disbursements method of accounting for the calendar year is required by the Commissioner to change to an accrual method effective with the year 1958. As of January 1, 1958, he had an

opening inventory of \$11,000. On December 31, 1958, he had a closing inventory of \$12,500. Merchandise purchases during the year amounted to \$22,500, and net sales were \$32,000. Total deductible business expenses were \$5,000. There were no receivables or payables at January 1, 1958. The computation of taxable income for 1958, assuming no other adjustments, using the new method of accounting follows:

Net sales	\$32,000
Opening inventory	\$11,000
Purchases	22,500
Total	33,500
Less closing inventory	12,500
Cost of goods sold	21,000
Gross profit	11,000
Business expenses	5,000
Business income	6,000
Personal exemption and itemized deductions	1,600
Taxable income	4,400

Under the cash receipts and disbursements method of accounting, only \$9,000 of the \$11,000 opening inventory had been included in the cost of goods sold and claimed as a deduction for the taxable years 1954 through 1957; the remaining \$2,000 had been so accounted for in pre-1954 years. In order to prevent the same item from reducing taxable income twice, an adjustment of \$9,000 must be made to the taxable income of 1958 under the provisions of section 481(a) and §1.481-1. Since the change in method of accounting was not initiated by the taxpayer, the \$2,000 of opening inventory which had been included in cost of goods sold in pre-1954 years is not taken into account. Taxable income for 1958 is accordingly increased by \$9,000 under section 481(a) to \$13,400. Assuming that the tax on \$13,400 is \$4,002 and that the tax on \$4,400 (income without the adjustment) is \$944, the increase in tax attributable to the adjustment, if taken into account for the taxable year of the change, would be the difference between the two, or \$3,058. Since the adjustment required by section 481(a) and §1.481-1 (\$9,000) increases taxable income by more than \$3,000, the increase in tax for the taxable year 1958 attributable to the adjustment of \$9,000 (i.e., \$3,058) may be limited under the provisions of section 481(b) (1) or (2). See examples (2) and (3).

Example 2. Assume that the taxpayer in Example 1 used the cash receipts and disbursements method of accounting in computing taxable income for the years 1956 and 1957 and that the taxable income for these years determined under such method was \$4,000 and \$6,000, respectively. The section 481(b)(1) limitation on tax with a pro rata three-year allocation of the \$9,000 adjustment is computed as follows:

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Taxable year	Taxable income before adjustment	Taxable income with adjustment	Assume total tax	Assumed tax before adjustment	Increase in tax attributable to adjustment
1956	\$4,000	\$7,000	\$1,660	\$840	\$820
1957	6,000	9,000	2,300	1,360	940
1958	4,400	7,400	1,780	944	836
Total .....	.....	.....	.....	.....	2,596

Since this increase in tax of \$2,596 is less than the increase in tax attributable to the inclusion of the entire adjustment in the income for the taxable year of the change (\$3,058), the limitation provided by section 481(b)(1) applies, and the total tax for 1958, the taxable year of the change, if section 481(b)(2) does not apply, is determined as follows:

Tax without any portion of adjustment	\$944
Increase in tax attributable to adjustment computed under section 481(b)(1)	2,596
Total tax for taxable year of the change	3,540

Example 3. (i) Assume the same facts as in Example 1 and, in addition, assume that the taxpayer used the cash receipts and disbursements method of accounting in computing taxable income for the years 1953 through 1957; that he established his taxable income under the new method for the taxable years 1953, 1954, and 1957, but did not have sufficient records to establish his taxable income under such method for the taxable years 1955 and 1956. The original taxable income and taxable income as redetermined are as follows:

Taxable year	Taxable income		Increase or (decrease) in taxable income
	Determined under cash receipts and disbursements method	Established under new method	
1953	\$5,000	\$7,000	\$2,000
1954	6,000	7,000	1,000
1955	5,500	(¹)	.....
1956	4,000	(¹)	.....
1957	6,000	10,000	4,000

¹ Undetermined.

As in examples (1) and (2), the total adjustment under section 481(a) is \$9,000. Of the \$9,000 adjustment, \$4,000 may be allocated to 1957, which is the only year consecutively preceding the taxable year of the change for which the taxpayer was able to establish his income under the new method. Since the income cannot be established under the new method for 1956 and 1955, no allocation may be made to 1954 or 1953, even though the tax-

payer has established his income for those years under the new method of accounting. The balance of \$5,000 (\$9,000 minus \$4,000) must be allocated to 1958.

(ii) The limitation provided by section 481(b)(2) is computed as follows: The tax for 1957, based on taxable income of \$6,000, is assumed to be \$1,360. Under the new method, based on taxable income of \$10,000, the tax for 1957 is assumed to be \$2,640, the increase attributable to \$4,000 of the \$9,000 section 481(a) adjustment being \$1,280, (\$2,640 minus \$1,360). The tax for 1958, computed on the basis of taxable income of \$4,400 (determined under the new method), is assumed to be \$944. The tax computed for 1958 on taxable income of \$9,400 (\$4,400 plus the \$5,000 adjustment allocated to 1958) is assumed to be \$2,436, leaving a difference of \$1,492 (\$2,436 minus \$944) attributable to the inclusion in 1958 of the portion of the total adjustment to be taken into account which could not be properly allocated to the taxable year or years consecutively preceding 1958.

(iii) The tax attributable to the adjustment is determined by selecting the smallest of the three following amounts:

Increase in tax attributable to adjustment computed under section 481(b)(2) (\$1,280 + \$1,492)	\$2,772
Increase in tax attributable to adjustment computed under section 481(b)(1) (Example 2)	2,596
Increase in tax if the entire adjustment is taken into account in the taxable year of the change (Example 1)	3,058

The final tax for 1958 is then \$3,540 computed as follows:

Tax before inclusion of any adjustment	\$944
Increase in tax attributable to adjustments (smallest of \$2,772, \$2,596 or \$3,058)	2,596
Total tax for 1958 (limited in accordance with section 481(b)(1))	3,540

Example 4. Assume that X Corporation has maintained its books of account and filed its income tax returns using the cash receipts and disbursements method of accounting for the years 1953 through 1957. The corporation secures permission to change to an accrual method of accounting for the calendar year 1958. The following tabulation presents the data with respect to the taxpayer's income for the years involved:

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Year	Taxable income under the cash receipts and disbursements method		Taxable income established under accrual method	Increase or (decrease) attributable to change	Changes in taxable income due to changes in net loss carryback
	Before application of net operating loss carryback	After application of net operating loss carryback			
1953	\$2,000	0	(¹)	.....	\$2,000
1954	4,000	\$1,000	(¹)	.....	3,000
1955	(5,000)	.....	\$1,000	\$6,000	.....
1956	80,000	80,000	77,000	(3,000)	.....
1957	90,000	90,000	96,000	6,000	.....
1958 .....	.....	.....	100,000	.....	.....

¹ Not established.

As indicated above, taxable income for 1953 and 1954, as determined under the cash receipts and disbursements method of accounting, was \$2,000 and \$4,000, respectively, and after application of the net operating loss carryback from 1955, the taxable income was reduced to zero in 1953 and to \$1,000 in 1954. The taxpayer was unable to establish taxable income for these years under an accrual method of accounting; however, under section 481(b)(3)(A), increases or decreases in the tax for taxable years to which no adjustment is allocated must, nevertheless, be taken into account to the extent the tax for such years would be affected by a net operating loss determined with reference to taxable years to which adjustments are allocated. The total amount of the adjustments required under section 481(a) and attributable to the taxable years 1953 through 1957 in this example is assumed to be \$10,000. The redetermination of taxable income established by the taxpayer for the taxable years

1955, 1956, and 1957 appears under the heading "Taxable income established under accrual method" in the above tabulation. The tabulation assumes that the taxpayer has been able to recompute the income for those years so as to establish a net adjustment of \$9,000, which leaves a balance of \$1,000 unaccounted for. In accordance with the requirements of section 481(b)(2), the \$1,000 amount is allocated to 1958, the taxable year of the change. The following computations are necessary in order to determine the tax attributable to the adjustments under section 481(a):

INCREASE IN TAX ATTRIBUTABLE TO INCLUSION IN 1958 OF THE ENTIRE \$10,000 ADJUSTMENT

Tax on income of 1958 increased by entire amount of adjustment (\$100,000 + \$10,000)	\$51,700
Tax on income of 1958 without adjustment (\$100,000)	46,500
Increase in tax attributable to inclusion of entire adjustment in year of the change	5,200

Increase in tax attributed to adjustment computed under section 481(b)(1)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1958	\$3,334	\$46,500	\$48,234	\$1,734
1957	3,333	41,300	43,033	1,733
1956	3,333	36,100	37,833	1,733
Increase in tax attributable to adjustment computed under section 481(b)(1) .....	.....	.....	.....	5,200

Increase in tax attributed to adjustment computed under section 481(b)(2)

1953	¹ \$2,000	0	¹ \$600	\$600
1954	¹ 3,000	\$300	¹ 1,200	900
1955	6,000	0	300	300
1956	(3,000)	36,100	34,540	(1,560)
1957	96,000	41,300	44,420	3,120
1958	² 1,000	46,500	² 47,020	520
Increase in tax attributable to the adjustment computed under section 481(b)(2) .....	.....	.....	.....	3,880

¹ Attributable to recomputations of net operating loss carrybacks determined with reference to net operating loss in 1955.

² Attributable to the inclusion of \$1,000 in the year of the change which represents the portion of the \$10,000 adjustment not allocated to taxable years prior to the year of the change for which taxable income is established under the new method.

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Since the limitation under section 481(b)(2) (\$3,880) on the amount of tax attributable to the adjustments is applicable, the final tax for the taxable year of the change is computed by adding such amount to the tax for that year computed without the inclusion of any amount attributable to the adjustments, that is, \$46,500 plus \$3,880, or \$50,380.

[T.D. 6500, 25 FR 11732, Nov. 26, 1960, as amended by T.D. 6490, 25 FR 8374, Sept. 1, 1960; T.D. 7301, 39 FR 963, Jan. 4, 1974; T.D. 8608, 60 FR 40078, Aug. 7, 1995]

§ 1.481-3 **Adjustments attributable to pre-1954 years where change was not initiated by taxpayer.**

If the adjustments required by section 481(a) and § 1.481-1 are attributable to a change in method of accounting which was not initiated by the taxpayer, no portion of any adjustments which is attributable to pre-1954 years shall be taken into account in computing taxable income. For example, if the total adjustments in the case of a change in method of accounting which is not initiated by the taxpayer amount to \$10,000, of which \$4,000 is attributable to pre-1954 years, only \$6,000 of the \$10,000 total adjustments is required to be taken into account under section 481 in computing taxable income. The portion of the adjustments which is attributable to pre-1954 years is the net amount of the adjustments which would have been required if the taxpayer had changed his method of accounting in his first taxable year which began after December 31, 1953, and ended after August 16, 1954.

[T.D. 6500, 25 FR 11735, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40079, Aug. 7, 1995]

§ 1.481-4 **Adjustments taken into account with consent.**

(a) In addition to the terms and conditions prescribed by the Commissioner under § 1.446-1(e)(3) for effecting a change in method of accounting, including the taxable year or years in which the amount of the adjustments required by section 481(a) is to be taken into account, or the methods of allocation described in section 481(b), a taxpayer may request approval of an alternative method of allocating the amount of the adjustments under section 481. See section 481(c). Requests for approval of an alternative method

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of allocation shall set forth in detail the facts and circumstances upon which the taxpayer bases its request. Permission will be granted only if the taxpayer and the Commissioner agree to the terms and conditions under which the allocation is to be effected. See § 1.446-1(e) for the rules regarding how to secure the Commissioner's consent to a change in method of accounting.

(b) An agreement to the terms and conditions of a change in method of accounting under § 1.446-1(e)(3), including the taxable year or years prescribed by the Commissioner under that section (or an alternative method described in paragraph (a) of this section) for taking the amount of the adjustments under section 481(a) into account, shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each year. The 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 **Eligible terminated S corporation.**

(a) *Scope.* Section 481(d)(2) of the Internal Revenue Code (Code) and this section provide rules relating to the qualification of a corporation as an eligible terminated S corporation (ETSC). Paragraph (b) of this section sets forth the requirements a corporation must meet to qualify as an ETSC. Paragraph (c) of this section describes certain transfers and other events that are disregarded for purposes of determining whether a corporation qualifies as an ETSC, as well as the treatment of revocations for which the effective date is the first day of the taxable year during which the revocation is made. Paragraph (d) of this section contains examples illustrating the rules of this section.

(b) *ETSC qualification.* For a C corporation to qualify as an ETSC, it must satisfy the following requirements:

(1) The corporation must have been an S corporation on December 21, 2017;

(2) During the 2-year period beginning on December 22, 2017, the corporation must have made a valid revocation of its S election under section 1362(d)(1) and the regulatory provisions in this part under section 1362 of the Code (revocation); and

(3) Except as provided in paragraph (c) of this section, the owners of the shares of stock of the corporation must be the same (and in identical proportions) on both:

(i) December 22, 2017; and

(ii) The day on which the revocation is made.

(c) *Special rules—(1) Certain disregarded events.* The following events are disregarded for purposes of determining whether the requirement in paragraph (b)(3) of this section is satisfied:

(i) Transfers of stock between a shareholder and that shareholder's trust treated as wholly owned by that shareholder under subpart E of subchapter J of chapter 1 of the Code;

(ii) Transfers of stock between a shareholder and an entity owned by that shareholder that is disregarded as separate from its owner under § 301.7701-2(c)(2)(i) of the Procedure and Administration Regulations;

(iii) An election by a shareholder trust to be treated as part of a decedent's estate under section 645 of the Code or the termination of an election under that section;

(iv) A change in the status of a shareholder trust from one type of eligible S corporation shareholder trust described in section 1361(c)(2)(A) of the Code to another type of eligible S corporation shareholder trust; for example, a trust to which the shares of stock were transferred pursuant to the terms of a will (testamentary trust) described in section 1361(c)(2)(A)(iii) that elects to become an electing small business trust described in section 1361(c)(2)(A)(v) and (e); and

(v) A transaction that includes more than one of the events described in this paragraph (c)(1).

(2) *Certain revocations.* For purposes of paragraphs (b)(2) and (b)(3)(ii) of this section, a revocation with an effective date that is the first day of the taxable

year during which the revocation is made pursuant to section 1362(d)(1)(C)(i) may be treated as having been made on the day the revocation was made or on the effective date of the revocation.

(d) *Examples.* Paragraphs (d)(1) through (3) of this section (*Examples 1 through 3*) illustrate the rules of this section. For purposes of paragraphs (d)(1) through (3) of this section (*Examples 1 through 3*), as of December 1, 2017, X is a calendar year S corporation with 100 shares of stock outstanding that is owned equally by unrelated individuals A and B. Pursuant to section 1362(d)(1) and §§ 1.1362-2 and 1.1362-6, X made a valid revocation of its S election on March 15, 2019, effective on January 1, 2019. X treats the revocation as having been made on March 15, 2019, for purposes of paragraphs (b)(2) and (b)(3)(ii). At all times, X has a single class of stock outstanding. Paragraphs (d)(1) through (3) of this section (*Examples 1 through 3*) describe all relevant transactions involving the X stock from December 1, 2017, until March 15, 2019.

(1) *Example 1—(i) Facts.* On June 5, 2018, A contributed 20 of its shares of X stock to Y, a wholly owned limited liability company that is disregarded as an entity separate from A pursuant to § 301.7701-2(c)(2)(i). On June 14, 2018, A contributed all of its interest in Y to Trust, which was a revocable trust treated as a wholly owned grantor trust of A pursuant to sections 671 and 676 of the Code. On December 27, 2018, B sold 10 shares of its X stock to C, an unrelated person.

(ii) *Analysis.* X is an ETSC if it satisfies the requirements of paragraph (b) of this section.

(A) *S corporation.* X was an S corporation on December 21, 2017. Therefore, X satisfies the requirement of paragraph (b)(1) of this section.

(B) *Date of revocation.* X made a valid revocation of its S election pursuant to section 1362(d)(1) on March 15, 2019, which is during the two-year period specified in paragraph (b)(2) of this section. Therefore, X satisfies the requirement of paragraph (b)(2) of this section.

(C) *Ownership.* For purposes of the requirement in paragraph (b)(3) of this

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section, the relevant dates are: December 22, 2017, and March 15, 2019 (the date X made a revocation of its S corporation status).

(1) *A's ownership interest.* As of December 22, 2017, A owned 50 shares of the outstanding shares of X stock. On June 5, 2018, A contributed 20 of its shares of X stock to Y (Transfer). On June 14, 2018, A contributed all of its interest in Y to Trust (Contribution). Both the Transfer and the Contribution are disregarded for purposes of determining whether the requirement of paragraph (b)(3) of this section is satisfied. See paragraphs (c)(2) and (1) of this section, respectively. Therefore, A owns 50 shares of the outstanding stock of X on March 15, 2019.

(2) *B's ownership interest.* As of December 22, 2017, B owned 50 shares of the outstanding shares of X stock. On December 27, 2018, B sold 10 shares to C. Therefore, B owns 40 shares of the outstanding stock of X on March 15, 2019.

(3) *C's ownership interest.* As of December 22, 2017, C owned no shares of X stock. On December 27, 2018, C purchased 10 shares from B. Therefore, C owns 10 shares of the outstanding stock of X on March 15, 2019.

(4) *Failure to satisfy the requirement in paragraph (b)(3) of this section.* As described in paragraphs (d)(1)(ii)(C)(2) and (3) of this section, B's and C's interest in X were not in the same proportions on December 22, 2017, and March 15, 2019. Therefore, X does not satisfy the requirement of paragraph (b)(3) of this section and does not qualify as an ETSC.

(iii) *Restoration of interests prior to end of PTTP.* If C transferred its shares of X stock back to B on February 1, 2019, then on December 22, 2017, and March 15, 2019, A and B will have owned 50 shares of the outstanding stock of X. Under these facts, X satisfies the requirement of paragraph (b)(3) of this section and qualifies as an ETSC.

(2) *Example 2—(i) Facts.* The facts are the same as in paragraph (d)(1)(i) of this section, except that B sold 10 shares of its X stock to C on December 18, 2017, in addition to the sale of 10 shares of X stock on December 27, 2018.

(ii) *Analysis.* The analysis in paragraph (d)(1)(ii)(A) and (B) of this section remains the same regarding the

requirements of paragraph (b)(1) and (2) of this section. With respect to the requirement of paragraph (b)(3) of this section, on December 22, 2017, A owned 50%, B owned 40%, and C owned 10% of the outstanding stock of X. As in paragraph (d)(1)(ii)(C)(1) of this section, the Transfer and the Contribution are disregarded for purposes of determining whether the requirement of paragraph (b)(3) of this section is satisfied. Therefore, on March 15, 2019, A owned 50% (50 shares), B owned 30% (30 shares), and C owned 20% (20 shares) of the outstanding shares of X. Even though A, B, and C owned shares of X on December 22, 2017, B's and C's proportionate ownership interest of X stock was not the same on December 22, 2017, and March 15, 2019. Therefore, X does not satisfy the requirement of paragraph (b)(3) of this section and does not qualify as an ETSC.

(3) *Example 3—(i) Facts.* The facts are the same as in paragraph (d)(1)(i) of this section, except that X made a valid revocation of its S election on November 1, 2019, effective on January 1, 2020.

(ii) *Analysis.* The analysis in paragraph (d)(1)(ii)(A) through (C) of this section remains the same regarding the requirements of paragraph (b)(1) through (3) of this section, except that the relevant dates are: December 22, 2017, and November 1, 2019 (the date X made a revocation of its S corporation status). Although the effective date of X's revocation of its S election (January 1, 2020) occurs after the conclusion of the two-year period specified in paragraph (b)(2) of this section, it is irrelevant for purposes of determining whether the requirements of paragraph (b)(2) and (3) of this section are satisfied.

[T.D. 9914, 85 FR 66476, Oct. 20, 2020]

§ 1.481-6 Effective dates; applicability dates.

(a) 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 26 CFR part 1, revised as of April 1, 1995.

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(b) Section 1.481-5 applies to taxable years beginning October 20, 2020. However, a corporation may choose to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years beginning on or before October 20, 2020. If a corporation makes the choice described in the previous sentence, the corporation must continue to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

[T.D. 9914, 85 FR 66478, Oct. 20, 2020]

§ 1.482-0 Outline of regulations under section 482.

This section contains major captions for §§ 1.482-1 through 1.482-9.

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

(b) Section 1.481-5 applies to taxable years beginning October 20, 2020. However, a corporation may choose to apply the rules in §§ 1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years beginning on or before October 20, 2020. If a corporation makes the choice described in the previous sentence, the corporation must continue to apply the rules in §§ 1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

[T.D. 9914, 85 FR 66478, Oct. 20, 2020]

§ 1.482-0 Outline of regulations under section 482.

This section contains major captions for §§ 1.482-1 through 1.482-9.

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

(a) In general.
(1) Purpose and scope.
(2) Authority to make allocations.
(3) Taxpayer's use of section 482.
(b) Arm's length standard.
(1) In general.
(2) Arm's length methods.
(i) Methods.
(ii) Selection of category of method applicable to transaction.
(iii) Coordination of methods applicable to certain intangible development arrangements.
(c) Best method rule.
(1) In general.
(2) Determining the best method.
(i) Comparability.
(ii) Data and assumptions.
(A) Completeness and accuracy of data.
(B) Reliability of assumptions.
(C) Sensitivity of results to deficiencies in data and assumptions.
(iii) Confirmation of results by another method.
(d) Comparability.
(1) In general.
(2) Standard of comparability.
(3) Factors for determining comparability.
(i) Functional analysis.
(ii) Contractual terms.
(A) In general.
(B) Identifying contractual terms.
(1) Written agreement.
(2) No written agreement.
(C) Examples.
(iii) Risk.
(A) In general.
(B) Identification of party that bears risk.
(C) Examples.
(iv) Economic conditions.
(v) Property or services.
(4) Special circumstances.
(i) Market share strategy.
(ii) Different geographic markets.
(A) In general.
(B) Example.
(C) Location savings.
(D) Example.
(iii) Transactions ordinarily not accepted as comparables.
(A) In general.
(B) Examples.
(e) Arm's length range.
(1) In general.
(2) Determination of arm's length range.
(i) Single method.
(ii) Selection of comparables.
(iii) Comparables included in arm's length range.
(A) In general.
(B) Adjustment of range to increase reliability.
(C) Interquartile range.
(3) Adjustment if taxpayer's results are outside arm's length range.
(4) Arm's length range not prerequisite to allocation.
(5) Examples.
(f) Scope of review.
(1) In general.
(i) Intent to evade or avoid tax not a prerequisite.
(ii) Realization of income not a prerequisite.
(A) In general.
(B) Example.
(iii) Nonrecognition provisions may not bar allocation.
(A) In general.
(B) Example.
(iv) Consolidated returns.
(2) Rules relating to determination of true taxable income.
(i) [Reserved]
(ii) Allocation based on taxpayer's actual transactions.
(A) In general.
(B) [Reserved]
(iii) Multiple year data.
(A) In general.
(B) Circumstances warranting consideration of multiple year data.
(C) Comparable effect over comparable period.
(D) Applications of methods using multiple year averages.
(E) Examples.
(iv) Product lines and statistical techniques.
(v) Allocations apply to results, not methods.
(A) In general.
(B) Example.
(g) Collateral adjustments with respect to allocations under section 482.
(1) In general.
(2) Correlative allocations.
(i) In general.
(ii) Manner of carrying out correlative allocation.

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- (iii) Events triggering correlative allocation.
- (iv) Examples.
- (3) Adjustments to conform accounts to reflect section 482 allocations.
 - (i) In general.
 - (ii) Example.
 - (4) Setoffs.
 - (i) In general.
 - (ii) Requirements.
 - (iii) Examples.
 - (h) Special rules.
 - (1) Small taxpayer safe harbor. [Reserved]
 - (2) Effect of foreign legal restrictions.
 - (i) In general.
 - (ii) Applicable legal restrictions.
 - (iii) Requirement for electing the deferred income method of accounting.
 - (iv) Deferred income method of accounting.
 - (v) Examples.
- (3) Coordination with section 936.
 - (i) Cost sharing under section 936.
 - (ii) Use of terms.
 - (i) Definitions.
 - (j) Effective/applicability date.

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

- (a) Loans or advances.
 - (1) Interest on bona fide indebtedness.
 - (i) In general.
 - (ii) Application of paragraph (a) of this section.
 - (A) Interest on bona fide indebtedness.
 - (B) Alleged indebtedness.
 - (iii) Period for which interest shall be charged.
 - (A) General rule.
 - (B) Exception for certain intercompany transactions in the ordinary course of business.
 - (C) Exception for trade or business of debtor member located outside the United States.
 - (D) Exception for regular trade practice of creditor member or others in creditor's industry.
 - (E) Exception for property purchased for resale in a foreign country.
 - (1) General rule.
 - (2) Interest-free period.
 - (3) Average collection period.
 - (4) Illustration.
 - (iv) Payment; book entries.
 - (2) Arm's length interest rate.
 - (i) In general.
 - (ii) Funds obtained at situs of borrower.
 - (iii) Safe haven interest rates for certain loans and advances made after May 8, 1986.
 - (A) Applicability.
 - (1) General rule.
 - (2) Grandfather rule for existing loans.
 - (B) Safe haven interest rate based on applicable Federal rate.
 - (C) Applicable Federal rate.
 - (D) Lender in business of making loans.
 - (E) Foreign currency loans.

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- (3) Coordination with interest adjustments required under certain other Internal Revenue Code sections.
- (4) Examples.
- (b) Rendering of services.
- (c) Use of tangible property.
 - (1) General rule.
 - (2) Arm's length charge.
 - (i) In general.
 - (ii) Safe haven rental charge.
 - (iii) Subleases.
 - (d) Transfer of property.
 - (e) Cost sharing arrangement.
 - (f) Effective/applicability Date.
 - (1) In general.
 - (2) Election to apply paragraph (b) to earlier taxable years.

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

- (a) In general.
- (b) Comparable uncontrolled price method.
 - (1) In general.
 - (2) Comparability and reliability considerations.
 - (i) In general.
 - (ii) Comparability.
 - (A) In general.
 - (B) Adjustments for differences between controlled and uncontrolled transactions.
 - (iii) Data and assumptions.
 - (3) Arm's length range.
 - (4) Examples.
 - (5) Indirect evidence of comparable uncontrolled transactions.
 - (i) In general.
 - (ii) Limitations.
 - (iii) Examples.
 - (c) Resale price method.
 - (1) In general.
 - (2) Determination of arm's length price.
 - (i) In general.
 - (ii) Applicable resale price.
 - (iii) Appropriate gross profit.
 - (iv) Arm's length range.
 - (3) Comparability and reliability considerations.
 - (i) In general.
 - (ii) Comparability.
 - (A) Functional comparability.
 - (B) Other comparability factors.
 - (C) Adjustments for differences between controlled and uncontrolled transactions.
 - (D) Sales agent.
 - (iii) Data and assumptions.
 - (A) In general.
 - (B) Consistency in accounting.
 - (4) Examples.
 - (d) Cost plus method.
 - (1) In general.
 - (2) Determination of arm's length price.
 - (i) In general.
 - (ii) Appropriate gross profit.
 - (iii) Arm's length range.
 - (3) Comparability and reliability considerations.

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- (i) In general.
- (ii) Comparability.
- (A) Functional comparability.
- (B) Other comparability factors.
- (C) Adjustments for differences between controlled and uncontrolled transactions.
- (D) Purchasing agent.
- (iii) Data and assumptions.
- (A) In general.
- (B) Consistency in accounting.
- (4) Examples.
- (e) Unspecified methods.
- (1) In general.
- (2) Example.
- (f) Coordination with intangible property rules.

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

- (a) In general.
- (b) Definition of intangible.
- (c) Comparable uncontrolled transaction method.
- (1) In general.
- (2) Comparability and reliability considerations.
 - (i) In general.
 - (ii) Reliability.
 - (iii) Comparability.
 - (A) In general.
 - (B) Factors to be considered in determining comparability.
 - (1) Comparable intangible property.
 - (2) Comparable circumstances.
 - (iv) Data and assumptions.
 - (3) Arm's length range.
 - (4) Examples.
 - (d) Unspecified methods.
 - (1) In general.
 - (2) Example.
 - (e) Coordination with tangible property rules.
 - (f) Special rules for transfers of intangible property.
 - (1) Form of consideration.
 - (2) Periodic adjustments.
 - (i) General rule.
 - (ii) Exceptions.
 - (A) Transactions involving the same intangible.
 - (B) Transactions involving comparable intangible.
 - (C) Methods other than comparable uncontrolled transaction.
 - (D) Extraordinary events.
 - (E) Five-year period.
 - (iii) Examples.
 - (3) Ownership of intangible property.
 - (i) Identification of owner.
 - (A) In general.
 - (B) Cost sharing arrangements.
 - (ii) Examples.
 - (4) Contribution to the value of intangible property owned by another.
 - (i) In general.
 - (ii) Examples.

- (5) Consideration not artificially limited.
- (6) Lump sum payments
- (i) In general.
- (ii) Exceptions.
- (iii) Example.
- (g) Coordination with rules governing cost sharing arrangements.
- (h) Effective/applicability date.
- (1) In general.
- (2) Election to apply regulation to earlier taxable years.

§ 1.482-5 Comparable profits method.

- (a) In general.
- (b) Determination of arm's length result.
- (1) In general.
- (2) Tested party.
- (i) In general.
- (ii) Adjustments for tested party.
- (3) Arm's length range.
- (4) Profit level indicators.
- (i) Rate of return on capital employed.
- (ii) Financial ratios.
- (iii) Other profit level indicators.
- (c) Comparability and reliability considerations.
 - (1) In general.
 - (2) Comparability.
 - (i) In general.
 - (ii) Functional, risk and resource comparability.
 - (iii) Other comparability factors.
 - (iv) Adjustments for differences between tested party and the uncontrolled taxpayers.
 - (3) Data and assumptions.
 - (i) In general.
 - (ii) Consistency in accounting.
 - (iii) Allocations between the relevant business activity and other activities.
 - (d) Definitions.
 - (e) Examples.

§ 1.482-6 Profit split method.

- (a) In general.
- (b) Appropriate share of profits and losses.
- (c) Application.
 - (1) In general.
 - (2) Comparable profit split.
 - (i) In general.
 - (ii) Comparability and reliability considerations.
 - (A) In general.
 - (B) Comparability.
 - (i) In general.
 - (2) Adjustments for differences between the controlled and uncontrolled taxpayers.
 - (C) Data and assumptions.
 - (D) Other factors affecting reliability.
 - (3) Residual profit split.
 - (i) In general.
 - (A) Allocate income to routine contributions.
 - (B) Allocate residual profit.
 - (i) Nonroutine contributions generally.
 - (2) Nonroutine contributions of intangible property.

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- (ii) Comparability and reliability considerations.
 - (A) In general.
 - (B) Comparability.
 - (C) Data and assumptions.
 - (D) Other factors affecting reliability
 - (d) Effective/applicability date.
 - (iii) Example.

§ 1.482-7 Methods to determine taxable income in connection with a cost sharing arrangement.

- (a) In general.
 - (1) RAB share method for cost sharing transactions (CSTs).
 - (2) Methods for platform contribution transactions (PCTs).
 - (3) Methods for other controlled transactions.
 - (i) Contribution to a CSA by a controlled taxpayer that is not a controlled participant.
 - (ii) Transfer of interest in a cost shared intangible.
 - (iii) Other controlled transactions in connection with a CSA.
 - (iv) Controlled transactions in the absence of a CSA.
 - (4) Coordination with the arm's length standard.
 - (b) Cost sharing arrangement.
 - (1) Substantive requirements.
 - (i) CSTs.
 - (ii) PCTs.
 - (iii) Divisional interests.
 - (iv) Examples.
 - (2) Administrative requirements.
 - (3) Date of a PCT.
 - (4) Divisional interests.
 - (i) In general.
 - (ii) Territorial based divisional interests.
 - (iii) Field of use based divisional interests.
 - (iv) Other divisional bases.
 - (v) Examples.
 - (5) Treatment of certain arrangements as CSAs.
 - (i) Situation in which Commissioner must treat arrangement as a CSA.
 - (ii) Situation in which Commissioner may treat arrangement as a CSA.
 - (iii) Examples.
 - (6) Entity classification of CSAs.
 - (c) Platform contributions.
 - (1) In general.
 - (2) Terms of platform contributions.
 - (i) Presumed to be exclusive.
 - (ii) Rebuttal of Exclusivity.
 - (iii) Proration of PCT Payments to the extent allocable to other business activities.
 - (A) In general.
 - (B) Determining the proration of PCT Payments.
 - (3) Categorization of the PCT.
 - (4) Certain make-or-sell rights excluded.
 - (i) In general.
 - (ii) Examples.
 - (5) Examples.
 - (d) Intangible development costs.
 - (1) Determining whether costs are IDCs.

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- (i) Definition and scope of the IDA.
- (ii) Reasonably anticipated cost shared intangible.
- (iii) Costs included in IDCs.
- (iv) Examples.
- (2) Allocation of costs.
- (3) Stock-based compensation.
 - (i) In general.
 - (ii) Identification of stock-based compensation with the IDA.
 - (iii) Measurement and timing of stock-based compensation IDC.
 - (A) In general.
 - (1) Transfers to which section 421 applies.
 - (2) Deductions of foreign controlled participants.
 - (3) Modification of stock option.
 - (4) Expiration or termination of CSA.
 - (B) Election with respect to options on publicly traded stock.
 - (1) In general.
 - (2) Publicly traded stock.
 - (3) Generally accepted accounting principles.
 - (4) Time and manner of making the election.
 - (C) Consistency.
 - (4) IDC share.
 - (5) Examples.
 - (e) Reasonably anticipated benefits share.
 - (1) Definition.
 - (i) In general.
 - (ii) Reliability.
 - (iii) Examples.
 - (2) Measure of benefits.
 - (i) In general.
 - (ii) Indirect bases for measuring anticipated benefits.
 - (A) Units used, produced, or sold.
 - (B) Sales.
 - (C) Operating profit.
 - (D) Other bases for measuring anticipated benefits.
 - (E) Examples.
 - (iii) Projections used to estimate benefits.
 - (A) In general.
 - (B) Examples.
 - (f) Changes in participation under a CSA.
 - (1) In general.
 - (2) Controlled transfer of interests.
 - (3) Capability variation.
 - (4) Arm's length consideration for a change in participation.
 - (5) Examples.
 - (g) Supplemental guidance on methods applicable to PCTs.
 - (1) In general.
 - (2) Best method analysis applicable for evaluation of a PCT pursuant to a CSA.
 - (i) In general.
 - (ii) Consistency with upfront contractual terms and risk allocation—the investor model.
 - (A) In general.
 - (B) Example.
 - (iii) Consistency of evaluation with realistic alternatives.

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(A) In general.
(B) Examples.
(iv) Aggregation of transactions.
(v) Discount rate.
(A) In general.
(B) Considerations in best method analysis of discount rate.
(1) Discount rate variation between realistic alternatives.
(2) [Reserved]
(3) Discount rate variation between forms of payment.
(4) Post-tax rate.
(C) Example.
(vi) Financial projections.
(vii) Accounting principles.
(A) In general.
(B) Examples.
(viii) Valuations of subsequent PCTs.
(A) Date of subsequent PCT.
(B) Best method analysis for subsequent PCT.
(ix) Arm's length range.
(A) In general.
(B) Methods based on two or more input parameters.
(C) Variable input parameters.
(D) Determination of arm's length PCT Payment.
(1) No variable input parameters.
(2) One variable input parameter.
(3) More than one variable input parameter.
(E) Adjustments.
(x) Valuation undertaken on a pre-tax basis.
(3) Comparable uncontrolled transaction method.
(4) Income method.
(i) In general.
(A) Equating cost sharing and licensing alternatives.
(B) Cost sharing alternative.
(C) Licensing alternative.
(D) Only one controlled participant with nonroutine platform contributions.
(E) Income method payment forms.
(F) Discount rates appropriate to cost sharing and licensing alternatives.
(G) The effect of taxation on determining the arm's length amount.
(ii) Evaluation of PCT Payor's cost sharing alternative.
(iii) Evaluation of PCT Payor's licensing alternative.
(A) Evaluation based on CUT.
(B) Evaluation based on CPM.
(iv) Lump sum payment form.
(v) [Reserved]
(vi) Best method analysis considerations.
(A) Coordination with § 1.482-1(c).
(B) Assumptions Concerning Tax Rates.
(C) Coordination with § 1.482-4(c)(2).
(D) Coordination with § 1.482-5(c).
(E) Certain Circumstances Concerning PCT Payor.
(F) Discount rates.
(1) Reflection of similar risk profiles of cost sharing alternative and licensing alternative.
(2) [Reserved]
(vii) Routine platform and operating contributions.
(viii) Examples.
(5) Acquisition Price Method.
(i) In general.
(ii) Determination of arm's length charge.
(iii) Adjusted acquisition price.
(iv) Best method analysis considerations.
(v) Example.
(6) Market capitalization method.
(i) In general.
(ii) Determination of arm's length charge.
(iii) Average market capitalization.
(iv) Adjusted average market capitalization.
(v) Best method analysis considerations.
(vi) Examples.
(7) Residual profit split method.
(i) In general.
(ii) Appropriate share of profits and losses.
(iii) Profit split.
(A) In general.
(B) Determine nonroutine residual divisional profit or loss.
(C) Allocate nonroutine residual divisional profit or loss.
(I) In general.
(2) Relative value determination.
(3) Determination of PCT Payments.
(4) Routine platform and operating contributions.
(iv) Best method analysis considerations.
(A) In general.
(B) Comparability.
(C) Data and assumptions.
(D) Other factors affecting reliability.
(v) Examples.
(8) Unspecified methods.
(h) Form of payment rules.
(1) CST Payments.
(2) PCT Payments.
(i) In general.
(ii) No PCT Payor stock.
(iii) Specified form of payment.
(A) In general.
(B) Contingent payments.
(C) Examples.
(iv) Conversion from fixed to contingent form of payment.
(3) Coordination of best method rule and form of payment.
(i) Allocations by the Commissioner in connection with a CSA.
(1) In general.
(2) CST allocations.
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§ 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

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income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482. Section 1.482-2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances or the use of tangible property. Sections 1.482-3 through 1.482-6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after January 5, 2009. Section 1.482-8 provides examples illustrating the application of the best method rule. Finally, §1.482-9 provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services.

(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

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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 1.482-7 and 1.482-9 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. This section provides general principles applicable in determining arm's length results of such controlled transactions, but do not provide methods, for which reference must be made to those other sections in accordance with paragraphs (b)(2)(ii) and (iii) of this section. Section 1.482-7 provides the specific methods to be used to evaluate whether a cost sharing arrangement as defined in §1.482-7 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.

(iii) *Coordination of methods applicable to certain intangible development arrangements.* Section 1.482-7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement as defined in §1.482-7. Sections 1.482-4 and 1.482-9, as appropriate, provide the specific methods to be used to determine arm's length results of arrangements, including partnerships, for sharing the costs and risks of developing intangibles, other than a cost sharing arrangement covered by §1.482-7. See also §§1.482-4(g) (Coordination with rules governing cost sharing arrangements) and 1.482-9(m)(3) (Coordination with rules governing cost sharing arrangements).

(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 methods in the case of a 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

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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 terms imputed from economic substance. (i) FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. In year 1, FP enters the United States market by selling YY wristwatches to its newly organized United States subsidiary, USSub, for distribution in the United States market. USSub pays FP a fixed price per wristwatch. USSub and FP undertake, without separate compensation, marketing activities to establish the YY trademark in the United States market. Unrelated foreign producers of trademarked wristwatches and their authorized United States distributors respectively undertake similar marketing activities in independent arrangements involving distribution of trademarked wristwatches in the United States market. In years 1 through 6, USSub markets and sells YY wristwatches in the United States. Further, in years 1 through 6, USSub undertakes incremental marketing activities in addition to the activities similar to those observed in the independent distribution transactions in the United States market. FP does not directly or indirectly compensate USSub for performing these incremental activities during years 1 through 6. Assume that, aside from these incremental activities, and after any adjustments are made to improve the reliability of the comparison, the price paid per wristwatch by the independent, authorized distributors of wristwatches would provide the most reliable measure of the arm's length price paid per YY wristwatch by USSub.

(ii) By year 7, the wristwatches with the YY trademark generate a premium return in the United States market, as compared to wristwatches marketed by the independent distributors. In year 7, substantially all the premium return from the YY trademark in the United States market is attributed to FP, for example through an increase in the price paid per watch by USSub, or by some other means.

(iii) In determining whether an allocation of income is appropriate in year 7, the Com-

missioner may consider the economic substance of the arrangements between USSub and FP, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in the incremental marketing activities to develop or enhance intangible property owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, USSub's undertaking the incremental marketing activities in years 1 through 6 is a course of conduct that is inconsistent with the parties' attribution to FP in year 7 of substantially all the premium return from the enhanced YY trademark in the United States market. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the YY trademark wristwatches. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for its incremental marketing activities in years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term, exclusive agreement to exploit the YY trademark in the United States that allows USSub to benefit from the incremental marketing activities it performed. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term, exclusive agreement to exploit the YY trademark in the United States, an agreement that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

Example 4. Contractual terms imputed from economic substance. (i) FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries worldwide. In year 1, FP enters into a licensing agreement that affords its newly organized United States subsidiary, USSub, exclusive rights to certain manufacturing and marketing intangible property (including the AA trademark) for purposes of manufacturing and marketing athletic gear in the United States under the AA trademark. The contractual terms of this agreement obligate USSub to pay FP a royalty based on sales, and also obligate both FP and USSub to undertake without separate compensation specified types and levels

of marketing activities. Unrelated foreign businesses license independent United States businesses to manufacture and market athletic gear in the United States, using trademarks owned by the unrelated foreign businesses. The contractual terms of these uncontrolled transactions require the licensees to pay royalties based on sales of the merchandise, and obligate the licensors and licensees to undertake without separate compensation specified types and levels of marketing activities. In years 1 through 6, USSub manufactures and sells athletic gear under the AA trademark in the United States. Assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangible property, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts in paragraph (ii) of this *Example 4*.

(ii) In years 1 through 6, USSub performs incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the license agreement with FP, that are also incremental as compared to those observed in the comparables. FP does not directly or indirectly compensate USSub for performing these incremental activities during years 1 through 6. By year 7, AA trademark athletic gear generates a premium return in the United States, as compared to similar athletic gear marketed by independent licensees. In year 7, USSub and FP enter into a separate services agreement under which FP agrees to compensate USSub on a cost basis for the incremental marketing activities that USSub performed during years 1 through 6, and to compensate USSub on a cost basis for any incremental marketing activities it may perform in year 7 and subsequent years. In addition, the parties revise the license agreement executed in year 1, and increase the royalty to a level that attributes to FP substantially all the premium return from sales of the AA trademark athletic gear in the United States.

(iii) In determining whether an allocation of income is appropriate in year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in the incremental marketing activities to develop or enhance intangible property owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of a future benefit. In this case, USSub's undertaking

the incremental marketing activities in years 1 through 6 is a course of conduct that is inconsistent with the parties' adoption in year 7 of contractual terms by which FP compensates USSub on a cost basis for the incremental marketing activities that it performed. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the AA trademark athletic gear. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for the incremental activities it performed during years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term, exclusive United States license agreement that allows USSub to benefit from the incremental activities. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term United States license agreement, a license that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in this particular case.

Example 5. Non-arm's length compensation.

(i) The facts are the same as in paragraph (i) of *Example 4*. As in *Example 4*, assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangible property, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts described in paragraph (ii) of this *Example 5*.

(ii) In years 1 through 4, USSub performs certain incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the basic license agreement, that are also incremental as compared with those activities observed in the comparables. At the start of year 1, FP enters into a separate services agreement with USSub, which states that FP will compensate USSub quarterly, in an amount equal to specified costs plus X%, for these incremental marketing functions. Further, these written agreements reflect the intent of the parties that USSub receive such compensation from FP throughout the term of the agreement, without regard to the success

or failure of the promotional activities. During years 1 through 4, USSub performs marketing activities pursuant to the separate services agreement and in each year USSub receives the specified compensation from FP on a cost of services plus basis.

(iii) In evaluating year 4, the Commissioner performs an analysis of independent parties that perform promotional activities comparable to those performed by USSub and that receive separately-stated compensation on a current basis without contingency. The Commissioner determines that the magnitude of the specified cost plus X% is outside the arm's length range in each of years 1 through 4. Based on an evaluation of all the facts and circumstances, the Commissioner makes an allocation to require payment of compensation to USSub for the promotional activities performed in year 4, based on the median of the interquartile range of the arm's length markups charged by the uncontrolled comparables described in paragraph (e)(3) of this section.

(iv) Given that based on facts and circumstances, the terms agreed by the controlled parties were that FP would bear all risks associated with the promotional activities performed by USSub to promote the AA trademark product in the United States market, and given that the parties' conduct during the years examined was consistent with this allocation of risk, the fact that the cost of services plus markup on USSub's services was outside the arm's length range does not, without more, support imputation of additional contractual terms based on alternative views of the economic substance of the transaction, such as terms indicating that USSub, rather than FP, bore the risk associated with these activities.

Example 6. Contractual terms imputed from economic substance. (i) Company X is a member of a controlled group that has been in operation in the pharmaceutical sector for many years. In years 1 through 4, Company X undertakes research and development activities. As a result of those activities, Company X developed a compound that may be more effective than existing medications in the treatment of certain conditions.

(ii) Company Y is acquired in year 4 by the controlled group that includes Company X. Once Company Y is acquired, Company X makes available to Company Y a large amount of technical data concerning the new compound, which Company Y uses to register patent rights with respect to the compound in several jurisdictions, making Company Y the legal owner of such patents. Company Y then enters into licensing agreements with group members that afford Company Y 100% of the premium return attributable to use of the intangible property by its subsidiaries.

(iii) In determining whether an allocation is appropriate in year 4, the Commissioner

may consider the economic substance of the arrangements between Company X and Company Y, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that an uncontrolled taxpayer operating at arm's length would make available the results of its research and development or perform services that resulted in transfer of valuable know how to another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, Company X's undertaking the research and development activities and then providing technical data and know-how to Company Y in year 4 is inconsistent with the registration and subsequent exploitation of the patent by Company Y. Therefore, the Commissioner may impute one or more agreements between Company X and Company Y consistent with the economic substance of their course of conduct, which would afford Company X an appropriate portion of the premium return from the patent rights. For example, the Commissioner may impute a separate services agreement that affords Company X contingent-payment compensation for its services in year 4 for the benefit of Company Y, consisting of making available to Company Y technical data, know-how, and other fruits of research and development conducted in previous years. These services benefited Company Y by giving rise to and contributing to the value of the patent rights that were ultimately registered by Company Y. In the alternative, the Commissioner may impute a transfer of patentable intangible property rights from Company X to Company Y immediately preceding the registration of patent rights by Company Y. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

(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;

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(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

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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 intangible property that is embedded in tangible property or services being transferred (embedded intangibles). The comparability of the embedded intangibles will be analyzed using the factors listed in § 1.482-4(c)(2)(iii)(B)(J) (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 and performance of services,

see §§ 1.482-3 through 1.482-6 and § 1.482-9; see also §§ 1.482-3(f), 1.482-4(f)(4), and 1.482-9(m), dealing with the coordination of intangible and tangible property and performance of services 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

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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

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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)(A) through (E) [Reserved]. For further guidance see § 1.482-1T(f)(2)(i)(A) through (E).

(ii) *Allocation based on taxpayer's actual transactions—(A) In general.* The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the Commissioner 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 Commissioner 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 paragraph (d)(3) of this section (factors for determining comparability; contractual terms and risk); §§ 1.482-3(e), 1.482-4(d), and 1.482-9(h) (unspecified methods).

(B) [Reserved]. For further guidance see § 1.482-1T(f)(2)(ii)(B).

(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 are 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 property 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 paragraph (d)(3)(iii) of this section (risk), paragraph (d)(4)(i) of this section (market share strategy), § 1.482-4(f)(2) (periodic adjustments), § 1.482-5 (comparable profits method), § 1.482-9(f) (comparable profits method for services), and § 1.482-9(i) (contingent-payment contractual terms for services). On the other hand, multiple year data ordinarily will not be considered for purposes of applying the comparable uncontrolled price method of § 1.482-3(b) or the comparable uncontrolled services price method of § 1.482-9(c) (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 dem-

onstrate 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

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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%.

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(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

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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 Commissioner will 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 paragraph (g)(4)(ii) of this section 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) of this section (arm's length standard), without regard to the rules in § 1.482-2(a) that treat certain interest rates as arm's length rates of interest.

(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 construction 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 § 1.482-9 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

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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 (i)(10) of this section apply to this section and §§1.482-2 through 1.482-9.

(1) *Organization* includes an organization of any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation

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(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 trans-

action 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.

(6)(i) The provisions of paragraphs (a)(1), (d)(3)(ii)(C) *Example 3*, *Example 4*, *Example 5*, and *Example 6*, (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii), and (i) of this section are generally applicable for taxable years beginning after July 31, 2009. The provision of paragraph (b)(2)(iii) of this section is generally applicable on January 5, 2009.

(ii) A person may elect to apply the provisions of paragraphs (a)(1), (b)(2)(i), (d)(3)(ii)(C) *Example 3*, *Example 4*, *Example 5*, and *Example 6*, (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii), and (i) of this section to earlier taxable years in accordance with the rules set forth in § 1.482-9(n)(2).

(7) [Reserved]. For further guidance see § 1.482-1T(j)(7).

[T.D. 8552, 59 FR 34990, July 8, 1994, as amended by T.D. 9088, 68 FR 51177, Aug. 26, 2003; T.D. 9278, 71 FR 44481, Aug. 4, 2006; 71 FR 76903, Dec. 22, 2006; T.D. 9441, 74 FR 351, Jan. 5, 2009; T.D. 9456, 74 FR 38839, Aug. 4, 2009; 74 FR 46345, Sept. 9, 2009; T.D. 9568, 76 FR 80089, Dec. 22, 2011; 77 FR 3606, Jan. 25, 2012; T.D. 9738, 80 FR 55541, Sept. 16, 2015]

§ 1.482-1T Allocation of income and deductions among taxpayers (temporary).

(a) through (f)(2) [Reserved]. For further guidance see § 1.482-1(a) through (f)(2).

(i) *Compensation independent of the form or character of controlled transaction—(A) In general.* All value provided between controlled taxpayers in

a controlled transaction requires an arm's length amount of compensation determined under the best method rule of § 1.482-1(c). Such amount must be consistent with, and must account for all of, the value provided between the parties in the transaction, without regard to the form or character of the transaction. For this purpose, it is necessary to consider the entire arrangement between the parties, as determined by the contractual terms, whether written or imputed in accordance with the economic substance of the arrangement, in light of the actual conduct of the parties. See, e.g., § 1.482-1(d)(3)(ii)(B) (identifying contractual terms) and (f)(2)(ii)(A) (regarding reference to realistic alternatives).

(B) *Aggregation.* The combined effect of two or more separate transactions (whether before, during, or after the year under review), including for purposes of an analysis under multiple provisions of the Code or regulations, may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of the transactions provides the most reliable measure of an arm's length result determined under the best method rule of § 1.482-1(c). Whether two or more transactions are evaluated separately or in the aggregate depends on the extent to which the transactions are economically interrelated and on the relative reliability of the measure of an arm's length result provided by an aggregate analysis of the transactions as compared to a separate analysis of each transaction. For example, consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation in the transactions is consistent with the value provided, including any synergies among items and services provided.

(C) *Coordinated best method analysis and evaluation.* Consistent with the principles of paragraphs (f)(2)(i)(A) and (B) of this section, a coordinated best method analysis and evaluation of two or more controlled transactions to which one or more provisions of the Code or regulations apply may be necessary to ensure that the overall value provided, including any synergies, is

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properly taken into account. A coordinated best method analysis would include a consistent consideration of the facts and circumstances of the functions performed, resources employed, and risks assumed in the relevant transactions, and a consistent measure of the arm's length results, for purposes of all relevant statutory and regulatory provisions.

(D) *Allocations of value.* In some cases, it may be necessary to allocate one or more portions of the arm's length result that was properly determined under a coordinated best method analysis described in paragraph (f)(2)(i)(C) of this section. Any such allocation of the arm's length result determined under the coordinated best method analysis must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result for each allocated amount. For example, if the full value of compensation due in controlled transactions whose tax treatment is governed by multiple provisions of the Code or regulations has been most reliably determined on an aggregate basis, then that full value must be allocated in a manner that provides the most reliable measure of each allocated amount.

(E) *Examples.* The following examples illustrate the provisions of this paragraph (f)(2)(i). For purposes of the examples in this paragraph (E), P is a domestic corporation, and S1, S2, and S3 are foreign corporations that are wholly owned by P.

Example 1. Aggregation of interrelated licensing, manufacturing, and selling activities. P enters into a license agreement with S1 that permits S1 to use a proprietary process for manufacturing product X and to sell product X to uncontrolled parties throughout a specified region. S1 uses the manufacturing process and sells its output to S2, which in turn resells the output to uncontrolled parties in the specified region. In evaluating whether the royalty paid by S1 to P is an arm's length amount, it may be appropriate to evaluate the royalty in combination with 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. Aggregation of interrelated manufacturing, marketing, and services activities. 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 whether the transfer prices paid by S1 to P, the fees paid by S2 to P for the use of P marketing intangibles, and the service fees earned by S2 and S3 are arm's length amounts, it would be appropriate to perform an aggregate analysis that considers the combined effects of these interrelated transactions if they are most reliably analyzed on an aggregated basis.

Example 3. Aggregation and reliability of comparable uncontrolled transactions. 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 constitute a controlled group of taxpayers (unrelated to the P controlled group) that 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. Non-aggregation of transactions that are not interrelated. P enters into a license agreement with S1 that permits S1 to use a proprietary 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 unrelated to product X. Product Y is resold by S1 to uncontrolled parties in the specified region. There is no connection between product X and product Y other than the fact that they are both sold in the same specified region. In evaluating whether 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 are arm's length amounts, it would not be appropriate to consider the combined effects of these separate and unrelated transactions.

Example 5. Aggregation of interrelated patents. P owns 10 individual patents that, in combination, can be used to manufacture and sell a successful product. P anticipates that it could earn profits of \$25x from the patents based on a discounted cash flow

analysis that provides a more reliable measure of the value of the patents exploited as a bundle rather than separately. P licenses all 10 patents to S1 to be exploited as a bundle. Evidence of uncontrolled licenses of similar individual patents indicates that, exploited separately, each license of each patent would warrant a price of \$1x, implying a total price for the patents of \$10x. Under paragraph (f)(2)(i)(B) of this section, in determining the arm's length royalty for the license of the bundle of patents, it would not be appropriate to use the uncontrolled licenses as comparables for the license of the bundle of patents, because, unlike the discounted cash flow analysis, the uncontrolled licenses considered separately do not reliably reflect the enhancement to value resulting from the interrelatedness of the 10 patents exploited as a bundle.

Example 6. Consideration of entire arrangement, including imputed contractual terms—(i) P conducts a business (“Business”) from the United States, with a worldwide clientele, but until Date X has no foreign operations. The success of Business significantly depends on intangibles (including marketing, manufacturing, technological, and goodwill or going concern value intangibles, collectively the “IP”), as well as ongoing support activities performed by P (including related research and development, central marketing, manufacturing process enhancement, and oversight activities, collectively “Support”), to maintain and improve the IP and otherwise maximize the profitability of Business.

(ii) On Date X, Year 1, P contributes the foreign rights to conduct Business, including the foreign rights to the IP, to newly incorporated S1. S1, utilizing the IP of which it is now the owner, commences foreign operations consisting of local marketing, manufacturing, and back office activities in order to conduct and expand Business in the foreign market.

(iii) Later, on Date Y, Year 1, P and S1 enter into a cost sharing arrangement (“CSA”) to develop and exploit the rights to conduct the Business. Under the CSA, P is entitled to the U.S. rights to conduct the Business, and S1 is entitled to the rest-of-the-world (“ROW”) rights to conduct the Business. P continues after Date Y to perform the Support, employing resources, capabilities, and rights that as a factual matter were not contributed to S1 in the Date X transaction, for the benefit of the Business worldwide. Pursuant to the CSA, P and S1 share the costs of P's Support in proportion to their reasonably anticipated benefit shares from their respective rights to the Business.

(iv) P treats the Date X transaction as a transfer described in section 351 that is subject to 367 and treats the Date Y transaction as the commencement of a CSA subject to section 482 and § 1.482-7. P takes the position

that the only platform contribution transactions (“PCTs”) in connection with the Date Y CSA consist of P's contribution of the U.S. Business IP rights and S1's contribution of the ROW Business IP rights of which S1 had become the owner on account of the prior Date X transaction.

(v) Pursuant to paragraph (f)(2)(i)(A) of this section, in determining whether an allocation of income is appropriate in Year 1 or subsequent years, the Commissioner may consider the economic substance of the entire arrangement between P and S1, including the parties' actual conduct throughout their relationship, regardless of the form or character of the contractual arrangement the parties have expressly adopted. The Commissioner determines that the parties' formal arrangement fails to reflect the full scope of the value provided between the parties in accordance with the economic substance of their arrangement. Therefore, the Commissioner may impute one or more agreements between P and S1, consistent with the economic substance of their arrangement, that fully reflect their respective reasonably anticipated commitments in terms of functions performed, resources employed, and risks assumed over time. For example, because P continues after Date Y to perform the Support, employing resources, capabilities, and rights not contributed to S1, for the benefit of the Business worldwide, the Commissioner may impute another PCT on Date Y pursuant to which P commits to so continuing the Support. See § 1.482-7(b)(1)(ii). The taxpayer may present additional facts that could indicate whether this or another alternative agreement best reflects the economic substance of the underlying transactions and course of conduct, provided that the taxpayer's position fully reflects the value of the entire arrangement consistent with the realistic alternatives principle.

Example 7. Distinguishing provision of value from characterization—(i) P developed a collection of resources, capabilities, and rights (“Collection”) that it uses on an interrelated basis in ongoing research and development of computer code that is used to create a successful line of software products. P can continue to use the Collection on such interrelated basis in the future to further develop computer code and, thus, further build on its successful line of software products. Under § 1.482-7(g)(2)(ix), P determines that the interquartile range of the net present value of its own use of the Collection in future research and development and software product marketing is between \$1000x and \$1100x, and this range provides the most reliable measure of the value to P of continuing to use the Collection on an interrelated basis in future research, development, and exploitation. Instead, P enters into an exchange described in section 351 in which it transfers

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certain intangible property related to the Collection to S1 for use in future research, development, and exploitation but continues to perform the same development functions that it did prior to the exchange, now on behalf of S1, under express or implied commitments in connection with S1's use of the intangible property. P takes the position that a portion of the Collection, consisting of computer code and related instruction manuals and similar intangible property (Portion 1), was transferrable intangible property and was the subject of the section 351 exchange and compensable under section 367(d). P claims that another portion of the Collection consists of items that either do not constitute property for purposes of section 367 or are not transferrable (Portion 2). P then takes the position that the value of Portion 2 does not give rise to income under section 367(d) or gain under section 367(a).

(ii) Under paragraphs (f)(2)(i)(A) and (C) of this section, any part of the value in Portion 2 that is not taken into account in an exchange under section 367 must nonetheless be evaluated under section 482 and the regulations thereunder to determine arm's length compensation for any value provided to S1. Accordingly, even if P's assertion that certain items were either not property or not capable of being transferred were correct, arm's length compensation is nonetheless required for all of the value associated with P's contributions under the section 482 regulations. Alternatively, the Commissioner may determine under all the facts and circumstances that P's assertion is incorrect and that the transaction in fact constitutes an exchange of property subject to, and therefore to be taken into account under, section 367. Thus, whether any item that P identifies as being within Portion 2 is properly characterized as property under section 367 (transferable or otherwise) is irrelevant because any value in Portion 2 that is provided to S1 must be compensated by S1 in a manner consistent with the \$1000x to \$1100x interquartile range of the overall value.

Example 8. Arm's length compensation for equivalent provisions of intangibles under sections 351 and 482. P owns the worldwide rights to manufacturing and marketing intangibles that it uses to manufacture and market a product in the United States ("US intangibles") and the rest of the world ("ROW intangibles"). P transfers all the ROW intangibles to S1 in an exchange described in section 351 and retains the US intangibles. Immediately after the exchange, P and S1 entered into a CSA described in § 1.482-7(b) that covers all research and development of intangibles conducted by the parties. A realistic alternative that was available to P and that would have involved the controlled parties performing similar functions, employing similar resources, and assuming similar risks as in the controlled transaction, was to

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transfer all ROW intangibles to S1 upon entering into the CSA in a platform contribution transaction described in § 1.482-7(c), rather than in an exchange described in section 351 immediately before entering into the CSA. Under paragraph (f)(2)(i)(A) of this section, the arm's length compensation for the ROW intangibles must correspond to the value provided between the parties, regardless of the form of the transaction. Accordingly, the arm's length compensation for the ROW intangibles is the same in both scenarios, and the analysis of the amount to be taken into account under section 367(d) pursuant to §§ 1.367(d)-1T(c) and 1.482-4 should include consideration of the amount that P would have charged for the realistic alternative determined under § 1.482-7(g) (and § 1.482-4, to the extent of any make-or-sell rights transferred). See §§ 1.482-1(b)(2)(iii) and 1.482-4(g).

Example 9. Aggregation of interrelated manufacturing and marketing intangibles governed by different statutes and regulations. The facts are the same as in *Example 8* except that P transfers only the ROW intangibles related to manufacturing to S1 in an exchange described in section 351 and, upon entering into the CSA, then transfers the ROW intangibles related to marketing to S1 in a platform contribution transaction described in § 1.482-7(c) (rather than transferring all ROW intangibles only upon entering into the CSA or only in a prior exchange described in section 351). The value of the ROW intangibles that P transferred in the two transactions is greater in the aggregate, due to synergies among the different types of ROW intangibles, than if valued as two separate transactions. Under paragraph (f)(2)(i)(B) of this section, the arm's length standard requires these synergies to be taken into account in determining the arm's length results for the transactions.

Example 10. Services provided using intangibles.—(i) P's worldwide group produces and markets Product X and subsequent generations of products, which result from research and development performed by P's R&D Team. Through this collaboration with respect to P's proprietary products, the members of the R&D Team have individually and as a group acquired specialized knowledge and expertise subject to non-disclosure agreements (collectively, "knowhow").

(ii) P arranges for the R&D Team to provide research and development services to create a new line of products, building on the Product X platform, to be owned and exploited by S1 in the overseas market. P asserts that the arm's length charge for the services is only reimbursement to P of its associated R&D Team compensation costs.

(iii) Even though P did not transfer the platform or the R&D Team to S1, P is providing value associated with the use of the platform, along with the value associated

with the use of the knowhow, to S1 by way of the services performed by the R&D Team for S1 using the platform and the knowhow. The R&D Team's use of intangible property, and any other valuable resources, in P's provision of services (regardless of whether the service effects a transfer of intangible property or valuable resources and regardless of whether the property is relatively high or low value) must be evaluated under the section 482 regulations, including the regulations specifically applicable to controlled services transactions in § 1.482-9, to ensure that P receives arm's length compensation for any value (attributable to such property or services) provided to S1 in a controlled transaction. See §§ 1.482-4 and 1.482-9(m). Under paragraph (f)(2)(i)(A) of this section, the arm's length compensation for the services performed by the R&D Team for S1 must be consistent with the value provided to S1, including the value of the knowhow and any synergies with the platform. Under paragraphs (f)(2)(i)(B) and (C) of this section, the best method analysis may determine that the compensation is most reliably determined on an aggregate basis reflecting the interrelated value of the services and embedded value of the platform and knowhow.

(iv) In the alternative, the facts are the same as above, except that P assigns to S1 all or a pertinent portion of the R&D Team and the relevant rights in the platform. P takes the position that, although the transferred platform rights must be compensated, the knowhow does not have substantial value independent of the services of any individual on the R&D Team and therefore is not an intangible within the meaning of § 1.482-4(b). In P's view, S1 owes no compensation to P on account of the R&D Team, as S1 will directly bear the cost of the relevant R&D Team compensation. However, in assembling and arranging to assign the relevant R&D Team, and thereby making available the value of the knowhow to S1, rather than other employees without the knowhow, P is performing services for S1 under imputed contractual terms based on the parties' course of conduct. Therefore, even if P's position were correct that the knowhow is not an intangible under § 1.482-4(b), a position that the Commissioner may challenge, arm's length compensation is required for all of the value that P provides to S1 through the interrelated provision of platform rights, knowhow, and services under paragraphs (f)(2)(i)(A), (B), and (C) of this section.

Example 11. Allocating arm's length compensation determined under an aggregate analysis—(i) P provides services to S1, which is incorporated in Country A. In connection with those services, P licenses intellectual property to S2, which is incorporated in Country B. S2 sublicenses the intellectual property to S1.

(ii) Under paragraph (f)(2)(i)(B) of this section, if an aggregate analysis of the service and license transactions provides the most reliable measure of an arm's length result, then an aggregate analysis must be performed. Under paragraph (f)(2)(i)(D) of this section, if an allocation of the value that results from such an aggregate analysis is necessary, for example, for purposes of sourcing the services income that P receives from S1 or determining deductible expenses incurred by S1, then the value determined under the aggregate analysis must be allocated using the method that provides the most reliable measure of the services income and deductible expenses.

(ii)(A) [Reserved]. For further guidance see § 1.482-1(f)(2)(ii)(A).

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

Example. P and S are controlled taxpayers. P licenses a proprietary process to S for S's use in 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 between P and S has economic substance, the Commissioner ordinarily will not restructure the taxpayer's transaction to treat P as if it had elected to exploit directly the manufacturing process. However, because P could have directly exploited the manufacturing process and manufactured product X itself, this realistic alternative may be taken into account under § 1.482-4(d) in determining the arm's length consideration for the controlled transaction. For examples of such an analysis, see *Examples 7 and 8* in paragraph (f)(2)(i)(E) of this section and the *Example* in § 1.482-4(d)(2).

(iii) through (j)(6) [Reserved]. For further guidance see § 1.482-1(f)(2)(iii) through (j)(6).

(7) *Certain effective/applicability dates—(i) Paragraphs (f)(2)(i)(A) through (E) and (f)(2)(ii)(B) of this section apply to taxable years ending on or after September 14, 2015.*

(ii) *Expiration date.* The applicability of paragraphs (f)(2)(i)(A) through (E) and (f)(2)(ii)(B) of this section expires on or before September 14, 2018.

[T.D. 9738, 80 FR 55541, Sept. 16, 2015]

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

(a) *Loans or advances—(1) Interest on bona fide indebtedness—(i) In general.*

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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).

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(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 to 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

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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

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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:

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

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

(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,

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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 semi-annually; or

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(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

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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

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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 1274(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) *Rendering of services.* For rules governing allocations under section 482 to reflect an arm's length charge for controlled transactions involving the rendering of services, see § 1.482-9.

(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.

(e) *Cost sharing arrangement.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving a cost sharing arrangement, see § 1.482-7.

(f) *Effective/applicability date*—(1) *In general.* The provision of paragraph (b) of this section is generally applicable for taxable years beginning after December 31, 2006. The provision of paragraph (e) of this section is generally applicable on January 5, 2009.

(2) *Election to apply paragraph (b) to earlier taxable years.* A person may elect to apply the provisions of paragraph (b) of this section to earlier taxable years in accordance with the rules set forth in § 1.482-9(n)(2).

[T.D. 8552, 59 FR 35002, July 8, 1994; 60 FR 16381, 16382, Mar. 30, 1995; T.D. 9278, 71 FR 44484, Aug. 4, 2006; T.D. 9456, 74 FR 38842, Aug. 4, 2009; T.D. 9568, 76 FR 80090, Dec. 22, 2011]

§ 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;

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

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

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(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 or-

dinarily 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.

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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

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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.

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(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 $20\% \times \$100$).

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 direc-

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tor 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

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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 reli-

ability 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.

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(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 meth-

ods 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 adjust-

ments 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

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the intangible, the exclusive or non-exclusive 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

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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 uniden-

tified 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, Lesssplit, 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 Lesssplit 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 Lesssplit was licensed. However, at the time that Lesssplit was licensed there were several other similar drugs already on the market to which Lesssplit was not in all cases superior. Consequently, the projected and actual Lesssplit profits were substantially less than the projected Nosplit profits. Thus, USdrug concludes that the profit potential of Lesssplit is not similar to the profit potential of Nosplit, and the Lesssplit 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

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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.

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(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 cir-

cumstances 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

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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

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	Profit projections	Actual profits
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)(7) 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) *Identification of owner—*(A) *In general.* The legal owner of intangible property pursuant to the intellectual

property law of the relevant jurisdiction, or the holder of rights constituting an intangible property pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective intangible property for purposes of this section unless such ownership is inconsistent with the economic substance of the underlying transactions. See §1.482-1(d)(3)(ii)(B) (identifying contractual terms). If no owner of the respective intangible property is identified under the intellectual property law of the relevant jurisdiction, or pursuant to contractual terms (including terms imputed pursuant to §1.482-1(d)(3)(ii)(B)) or other legal provision, then the controlled taxpayer who has control of the intangible property, based on all the facts and circumstances, will be considered the sole owner of the intangible property for purposes of this section.

(B) *Cost sharing arrangements.* The rules in this paragraph (f)(3) regarding ownership with respect to cost shared intangibles and cost sharing arrangements will apply only as provided in §1.482-7.

(ii) *Examples.* The principles of this paragraph (f)(3) are illustrated by the following examples:

Example 1. FP, a foreign corporation, is the registered holder of the AA trademark in the United States. FP licenses to its U.S. subsidiary, USSub, the exclusive rights to manufacture and market products in the United States under the AA trademark. FP is the owner of the trademark pursuant to intellectual property law. USSub is the owner of the license pursuant to the terms of the license, but is not the owner of the trademark. See paragraphs (b)(3) and (4) of this section (defining an intangible as, among other things, a trademark or a license).

Example 2. The facts are the same as in *Example 1*. As a result of its sales and marketing activities, USSub develops a list of several hundred creditworthy customers that regularly purchase AA trademarked products. Neither the terms of the contract between FP and USSub nor the relevant intellectual property law specify which party owns the customer list. Because USSub has knowledge of the contents of the list, and has practical control over its use and dissemination, USSub is considered the sole owner of the customer list for purposes of this paragraph (f)(3).

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(4) *Contribution to the value of intangible property owned by another*—(i) *In general.* The arm's length consideration for a contribution by one controlled taxpayer that develops or enhances the value, or may be reasonably anticipated to develop or enhance the value, of intangible property owned by another controlled taxpayer will be determined in accordance with the applicable rules under section 482. If the consideration for such a contribution is embedded within the contractual terms for a controlled transaction that involves such intangible property, then ordinarily no separate allocation will be made with respect to such contribution. In such cases, pursuant to § 1.482-1(d)(3), the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's length consideration in the controlled transaction.

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

Example 1. A, a member of a controlled group, allows B, another member of the controlled group, to use tangible property, such as laboratory equipment, in connection with B's development of an intangible that B owns. By furnishing tangible property, A makes a contribution to the development of intangible property owned by another controlled taxpayer, B. Pursuant to paragraph (f)(4)(i) of this section, the arm's length charge for A's furnishing of tangible property will be determined under the rules for use of tangible property in § 1.482-2(c).

Example 2. (i) *Facts.* FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. FP enters into an exclusive, five-year, renewable agreement with its newly organized U.S. subsidiary, USSub. The contractual terms of the agreement grant USSub the exclusive right to re-sell YY trademark wristwatches in the United States, obligate USSub to pay a fixed price per wristwatch throughout the entire term of the contract, and obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities.

(ii) The consideration for FP's and USSub's marketing activities, as well as the consideration for the exclusive right to re-sell YY trademarked merchandise in the United States, are embedded in the transfer price paid for the wristwatches. Accordingly, pursuant to paragraph (f)(4)(i) of this section,

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ordinarily no separate allocation would be appropriate with respect to these embedded contributions.

(iii) Whether an allocation is warranted with respect to the transfer price for the wristwatches is determined under §§ 1.482-1, 1.482-3, and this section through § 1.482-6. The comparability analysis would include consideration of all relevant factors, including the nature of the intangible property embedded in the wristwatches and the nature of the marketing activities required under the agreement. This analysis would also take into account that the compensation for the activities performed by USSub and FP, as well as the consideration for USSub's use of the YY trademark, is embedded in the transfer price for the wristwatches, rather than provided for in separate agreements. See §§ 1.482-3(f) and 1.482-9(m)(4).

Example 3. (i) *Facts.* FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries. In year 1, FP licenses to a newly organized U.S. subsidiary, USSub, the exclusive rights to use certain manufacturing and marketing intangible property to manufacture and market athletic gear in the United States under the AA trademark. The license agreement obligates USSub to pay a royalty based on sales of trademarked merchandise. The license agreement also obligates FP and USSub to perform without separate compensation specified types and levels of marketing activities. In year 1, USSub manufactures and sells athletic gear under the AA trademark in the United States.

(ii) The consideration for FP's and USSub's respective marketing activities is embedded in the contractual terms of the license for the AA trademark. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to the embedded contributions in year 1. See § 1.482-9(m)(4).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement would be analyzed under § 1.482-1, and this section through § 1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangible property subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. Pursuant to paragraph (f)(4)(i) of this section, the analysis would also take into account the fact that the compensation for the marketing services is embedded in the royalty paid for use of the AA trademark, rather than provided for in a separate services agreement. For illustrations of application of the best method rule, see § 1.482-8 Examples 10, 11, and 12.

Example 4. (i) *Facts.* The year 1 facts are the same as in *Example 3*, with the following

exceptions. In year 2, USSub undertakes certain incremental marketing activities in addition to those required by the contractual terms of the license for the AA trademark executed in year 1. The parties do not execute a separate agreement with respect to these incremental marketing activities performed by USSub. The license agreement executed in year 1 is of sufficient duration that it is reasonable to anticipate that USSub will obtain the benefit of its incremental activities, in the form of increased sales or revenues of trademarked products in the U.S. market.

(ii) To the extent that it was reasonable to anticipate that USSub's incremental marketing activities would increase the value only of USSub's intangible property (that is, USSub's license to use the AA trademark for a specified term), and not the value of the AA trademark owned by FP, USSub's incremental activities do not constitute a contribution for which an allocation is warranted under paragraph (f)(4)(i) of this section.

Example 5. (i) *Facts.* The year 1 facts are the same as in *Example 3*. In year 2, FP and USSub enter into a separate services agreement that obligates USSub to perform certain incremental marketing activities to promote AA trademark athletic gear in the United States, above and beyond the activities specified in the license agreement executed in year 1. In year 2, USSub begins to perform these incremental activities, pursuant to the separate services agreement with FP.

(ii) Whether an allocation is warranted with respect to USSub's incremental marketing activities covered by the separate services agreement would be evaluated under §§ 1.482-1 and 1.482-9, including a comparison of the compensation provided for the services with the results obtained under a method pursuant to § 1.482-9, selected and applied in accordance with the best method rule of § 1.482-1(c).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement is determined under § 1.482-1, and this section through § 1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangible property subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. The comparability analysis would take into account that the compensation for the incremental activities by USSub is provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, see § 1.482-8 *Examples 10, 11, and 12*.

Example 6. (i) *Facts.* The year 1 facts are the same as in *Example 3*. In year 2, FP and USSub enter into a separate services agreement that obligates FP to perform incremental marketing activities, not specified in the year 1 license, by advertising AA trademarked athletic gear in selected international sporting events, such as the Olympics and the soccer World Cup. FP's corporate advertising department develops and coordinates these special promotions. The separate services agreement obligates USSub to pay an amount to FP for the benefit to USSub that may reasonably be anticipated as the result of FP's incremental activities. The separate services agreement is not a qualified cost sharing arrangement under § 1.482-7T. FP begins to perform the incremental activities in year 2 pursuant to the separate services agreement.

(ii) Whether an allocation is warranted with respect to the incremental marketing activities performed by FP under the separate services agreement would be evaluated under § 1.482-9. Under the circumstances, it is reasonable to anticipate that FP's activities would increase the value of USSub's license as well as the value of FP's trademark. Accordingly, the incremental activities by FP may constitute in part a controlled services transaction for which USSub must compensate FP. The analysis of whether an allocation is warranted would include a comparison of the compensation provided for the services with the results obtained under a method pursuant to § 1.482-9, selected and applied in accordance with the best method rule of § 1.482-1(c).

(iii) Whether an allocation is appropriate with respect to the royalty under the license agreement would be evaluated under §§ 1.482-1 through 1.482-3, this section, and §§ 1.482-5 and 1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of USSub's license, the nature of the intangible property subject to the license, and the marketing activities required to be undertaken by both FP and USSub pursuant to the license. This comparability analysis would take into account that the compensation for the incremental activities performed by FP was provided for in the separate services agreement, rather than embedded in the royalty paid for use of the AA trademark. For illustrations of application of the best method rule, see § 1.482-8, *Example 10, Example 11, and Example 12*.

(5) *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

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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.

(6) *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

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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.

(g) *Coordination with rules governing cost sharing arrangements*. Section 1.482-7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement. This section provides the specific methods to be used to determine arm's length results of a transfer of intangible property, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by § 1.482-7. In the case of such an arrangement, consideration of the principles, methods, comparability, and reliability considerations set forth in § 1.482-7 is relevant in determining the best method, including an unspecified method, under this section, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

(h) *Effective/applicability date*—(1) *In general*. Except as provided in the succeeding sentence, the provisions of paragraphs (f)(3) and (4) of this section are generally applicable for taxable

years beginning after December 31, 2006. The provisions of paragraphs (f)(3)(i)(B) and (g) of this section are generally applicable on January 5, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraphs (f)(3) and (4) of this section to earlier taxable years in accordance with the rules set forth in § 1.482-9(n)(2).

[T.D. 8552, 59 FR 35016, July 8, 1994; T.D. 9278, 71 FR 44484, Aug. 4, 2006; T.D. 9456, 74 FR 38842, Aug. 4, 2009; T.D. 9568, 76 FR 80090, Dec. 22, 2011]

§ 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

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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

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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)(3)(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

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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.

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(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 tax payers to distribute the product. Similar products are produced by other companies but none of them is sold to uncontrolled tax payers 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 (per-cent)	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

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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 (per- cent)	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

	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 de-

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(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:

velops 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.

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(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; T.D. 9441, 74 FR 352, Jan. 5, 2009; T.D. 9568, 76 FR 80090, Dec. 22, 2011]

§ 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,

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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) or §1.482-9(f)(2)(iii) 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, 1.482-5, and 1.482-9, 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 intangible property 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, 1.482-5 and 1.482-9.

(B) *Allocate residual profit*—(1) *Nonroutine contributions generally.* The allocation of income to the controlled taxpayer's routine contributions will not reflect profits attributable to each controlled taxpayer's contributions to the relevant business activity that are not routine (nonroutine contributions). A nonroutine contribution is a contribution that is not accounted for as a routine contribution. Thus, in cases where

such nonroutine contributions 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 nonroutine contributions to the relevant business activity. The relative value of the nonroutine contributions of each taxpayer should be measured in a manner that most reliably reflects each nonroutine contribution made to the controlled transaction and each controlled taxpayer's role in the nonroutine contributions. If the nonroutine contribution 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 nonroutine contribution must be made among all the business activities in which it is used.

(2) *Nonroutine contributions of intangible property.* In many cases, nonroutine contributions of a taxpayer to the relevant business activity may be contributions of intangible property. For purposes of paragraph (c)(3)(i)(B)(1) of this section, the relative value of nonroutine intangible property contributed by taxpayers may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of nonroutine intangible property contributions may be estimated by the capitalized cost of developing the intangible property and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible property. Finally, if the intangible property development expenditures of the parties are relatively constant over time and the useful life of the intangible property contributed by all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of nonroutine intangible property contributions.

(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,

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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, 1.482-5, and 1.482-9, 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\% \times \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

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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.

(d) *Effective/applicability date*—(1) *In general.* The provisions of paragraphs (c)(2)(ii)(B)(1) and (D), (c)(3)(i)(A) and (B), and (c)(3)(ii)(D) of this section are generally applicable for taxable years beginning after July 31, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraphs (c)(2)(ii)(B)(1) and (D), (c)(3)(i)(A) and (B), and (c)(3)(ii)(D) of this section to earlier taxable years in accordance with the rules set forth in § 1.482-9(n)(2).

[T.D. 8552, 59 FR 35025, July 8, 1994; 60 FR 16382, Mar. 30, 1995, as amended by T.D. 9278, 71 FR 44486, Aug. 4, 2006; T.D. 9456, 74 FR 38844, Aug. 4, 2009; 74 FR 46345, Sept. 9, 2009]

§ 1.482-7 Methods to determine taxable income in connection with a cost sharing arrangement.

(a) *In general.* The arm's length amount charged in a controlled transaction reasonably anticipated to contribute to developing intangibles pursuant to a cost sharing arrangement (CSA), as described in paragraph (b) of this section, must be determined under a method described in this section. Each method must be applied in accordance with the provisions of § 1.482-1, except as those provisions are modified in this section.

(1) *RAB share method for cost sharing transactions (CSTs).* See paragraph (b)(1)(i) of this section regarding the requirement that controlled participants, as defined in section (j)(1)(i) of

this section, share intangible development costs (IDCs) in proportion to their shares of reasonably anticipated benefits (RAB shares) by entering into cost sharing transactions (CSTs).

(2) *Methods for platform contribution transactions (PCTs).* The arm's length amount charged in a platform contribution transaction (PCT) described in paragraph (b)(1)(ii) of this section must be determined under the method or methods applicable under the other section or sections of the section 482 regulations, as supplemented by paragraph (g) of this section. See § 1.482-1(b)(2)(ii) (Selection of category of method applicable to transaction), § 1.482-1(b)(2)(iii) (Coordination of methods applicable to certain intangible development arrangements), and paragraph (g) of this section (Supplemental guidance on methods applicable to PCTs).

(3) *Methods for other controlled transactions*—(i) *Contribution to a CSA by a controlled taxpayer that is not a controlled participant.* If a controlled taxpayer that is not a controlled participant contributes to developing a cost shared intangible, as defined in section (j)(1)(i) of this section, it must receive consideration from the controlled participants under the rules of § 1.482-4(f)(4) (Contribution to the value of an intangible owned by another). Such consideration will be treated as an intangible development cost for purposes of paragraph (d) of this section.

(ii) *Transfer of interest in a cost shared intangible.* If at any time (during the term, or upon or after the termination, of a CSA) a controlled participant transfers an interest in a cost shared intangible to another controlled taxpayer, the controlled participant must receive an arm's length amount of consideration from the transferee under the rules of §§ 1.482-4 through 1.482-6 as supplemented by paragraph (f)(4) of this section regarding arm's length consideration for a change in participation. For this purpose, a capability variation described in paragraph (f)(3) of this section is considered to be a controlled transfer of interests in cost shared intangibles.

(iii) *Other controlled transactions in connection with a CSA.* Controlled

transactions between controlled participants that are not PCTs or CSTs and are not described in paragraph (a)(3)(ii) of this section (for example, provision of a cross operating contribution, as defined in paragraph (j)(1)(i) of this section, or make-or-sell rights, as defined in paragraph (c)(4) of this section) require arm's length consideration under the rules of §§ 1.482-1 through 1.482-6, and 1.482-9 as supplemented by paragraph (g)(2)(iv) of this section.

(iv) *Controlled transactions in the absence of a CSA.* If a controlled transaction is reasonably anticipated to contribute to developing intangibles pursuant to an arrangement that is not a CSA described in paragraph (b)(1) or (5) of this section, whether the results of any such controlled transaction are consistent with an arm's length result must be determined under the applicable rules of the other sections of the regulations under section 482. For example, an arrangement for developing intangibles in which one controlled taxpayer's costs of developing the intangibles significantly exceeds its share of reasonably anticipated benefits from exploiting the developed intangibles would not in substance be a CSA, as described in paragraphs (b)(1)(i) through (iii) of this section or paragraph (b)(5)(i) of this section. In such a case, unless the rules of this section are applicable by reason of paragraph (b)(5) of this section, the arrangement must be analyzed under other applicable sections of regulations under section 482 to determine whether it achieves arm's length results, and if not, to determine any allocations by the Commissioner that are consistent with such other regulations under section 482. See § 1.482-1(b)(2)(ii) (Selection of category of method applicable to transaction) and (iii) (Coordination of methods applicable to certain intangible development arrangements).

(4) *Coordination with the arm's length standard.* A CSA 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 IDC share (as determined under paragraph (d)(4) of this section) equals its RAB share, each controlled participant compensates its RAB share

of the value of all platform contributions by other controlled participants, and all other requirements of this section are satisfied.

(b) *Cost sharing arrangement.* A cost sharing arrangement is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their RAB shares. An arrangement is a CSA if and only if the requirements of paragraphs (b)(1) through (4) of this section are met.

(1) *Substantive requirements—(i) CSTs.* All controlled participants must commit to, and in fact, engage in cost sharing transactions. In CSTs, the controlled participants make payments to each other (CST Payments) as appropriate, so that in each taxable year each controlled participant's IDC share is in proportion to its respective RAB share.

(ii) *PCTs.* All controlled participants must commit to, and in fact, engage in platform contributions transactions to the extent that there are platform contributions pursuant to paragraph (c) of this section. In a PCT, each other controlled participant (PCT Payor) is obligated to, and must in fact, make arm's length payments (PCT Payments) to each controlled participant (PCT Payee) that provides a platform contribution. For guidance on determining such arm's length obligation, see paragraph (g) of this section.

(iii) *Divisional interests.* Each controlled participant must receive a non-overlapping interest in the cost shared intangibles without further obligation to compensate another controlled participant for such interest.

(iv) *Examples.* The following examples illustrate the principles of this paragraph (b)(1):

Example 1. Company A and Company B, who are members of the same controlled group, execute an agreement to jointly develop vaccine X and own the exclusive rights to commercially exploit vaccine X in their respective territories, which together comprise the whole world. The agreement provides that they will share some, but not all, of the costs for developing Vaccine X in proportion to RAB share. Such agreement is not a CSA because Company A and Company B have not agreed to share all of the IDCs in proportion to their respective RAB shares.

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Example 2. Company A and Company B agree to share all the costs of developing Vaccine X. The agreement also provides for employing certain resources and capabilities of Company A in this program including a skilled research team and certain research facilities, and provides for Company B to make payments to Company A in this respect. However, the agreement expressly provides that the program will not employ, and so Company B is expressly relieved of the payments in regard to, certain software developed by Company A as a medical research tool to model certain cellular processes expected to be implicated in the operation of Vaccine X even though such software would reasonably be anticipated to be relevant to developing Vaccine X and, thus, would be a platform contribution. See paragraph (c) of this section. Such agreement is not a CSA because Company A and Company B have not engaged in a necessary PCT for purposes of developing Vaccine X.

Example 3. Companies C and D, who are members of the same controlled group, enter into a CSA. In the first year of the CSA, C and D conduct the intangible development activity, as described in paragraph (d)(1) of this section. The total IDCs in regard to such activity are \$3,000,000 of which C and D pay \$2,000,000 and \$1,000,000, respectively, directly to third parties. As between C and D, however, their CSA specifies that they will share all IDCs in accordance with their RAB shares (as described in paragraph (e)(1) of this section), which are 60% for C and 40% for D. It follows that C should bear \$1,800,000 of the total IDCs (60% of total IDCs of \$3,000,000) and D should bear \$1,200,000 of the total IDCs (40% of total IDCs of \$3,000,000). D makes a CST payment to C of \$200,000, that is, the amount by which D's share of IDCs in accordance with its RAB share exceeds the amount of IDCs initially borne by D (\$1,200,000-\$1,000,000), and which also equals the amount by which the total IDCs initially borne by C exceeds its share of IDCs in accordance with its RAB share (\$2,000,000-\$1,800,000). As a result of D's CST payment to C, the IDC shares of C and D are in proportion to their respective RAB shares.

(2) *Administrative requirements.* The CSA must meet the requirements of paragraph (k) of this section.

(3) *Date of a PCT.* The controlled participants must enter into a PCT as of the earliest date on or after the CSA is entered into on which a platform contribution is reasonably anticipated to contribute to developing cost shared intangibles.

(4) *Divisional interests—(i) In general.* Pursuant to paragraph (b)(1)(iii) of this section, each controlled participant

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must receive a non-overlapping interest in the cost shared intangibles without further obligation to compensate another controlled participant for such interest. Each controlled participant must be entitled to the perpetual and exclusive right to the profits from transactions of any member of the controlled group that includes the controlled participant with uncontrolled taxpayers to the extent that such profits are attributable to such interest in the cost shared intangibles.

(ii) *Territorial based divisional interests.* The CSA may divide all interests in cost shared intangibles on a territorial basis as follows. The entire world must be divided into two or more non-overlapping geographic territories. Each controlled participant must receive at least one such territory, and in the aggregate all the participants must receive all such territories. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost shared intangibles through the use, consumption, or disposition of property or services in its territories. Thus, compensation will be required if other members of the controlled group exploit the cost shared intangibles in such territory.

(iii) *Field of use based divisional interests.* The CSA may divide all interests in cost shared intangibles on the basis of all uses (whether or not known at the time of the division) to which cost shared intangibles are to be put as follows. All anticipated uses of cost shared intangibles must be identified. Each controlled participant must be assigned at least one such anticipated use, and in the aggregate all the participants must be assigned all such anticipated uses. Each controlled participant will be assigned the perpetual and exclusive right to exploit the cost shared intangibles through the use or uses assigned to it and one controlled participant must be assigned the exclusive and perpetual right to exploit cost shared intangibles through any unanticipated uses.

(iv) *Other divisional bases.* (A) In the event that the CSA does not divide interests in the cost shared intangibles on the basis of exclusive territories or fields of use as described in paragraphs (b)(4)(ii) and (iii) of this section, the

CSA may adopt some other basis on which to divide all interests in the cost shared intangibles among the controlled participants, provided that each of the following criteria is met:

(1) The basis clearly and unambiguously divides all interests in cost shared intangibles among the controlled participants.

(2) The consistent use of such basis for the division of all interests in the cost shared intangibles can be dependably verified from the records maintained by the controlled participants.

(3) The rights of the controlled participants to exploit cost shared intangibles are non-overlapping, exclusive, and perpetual.

(4) The resulting benefits associated with each controlled participant's interest in cost shared intangibles are predictable with reasonable reliability.

(B) See paragraph (f)(3) of this section for rules regarding the requirement of arm's length consideration for changes in participation in CSAs involving divisions of interest described in this paragraph (b)(4)(iv).

(v) *Examples.* The following examples illustrate the principles of this paragraph (b)(4):

Example 1. Companies P and S, both members of the same controlled group, enter into a CSA to develop product Z. Under the CSA, P receives the interest in product Z in the United States and S receives the interest in product Z in the rest of the world, as described in paragraph (b)(4)(ii) of this section. Both P and S have plants for manufacturing product Z located in their respective geographic territories. However, for commercial reasons, product Z is nevertheless manufactured by P in the United States for sale to customers in certain locations just outside the United States in close proximity to P's U.S. manufacturing plant. Because S owns the territorial rights outside the United States, P must compensate S to ensure that S realizes all the cost shared intangible profits from P's sales of product Z in S's territory. The pricing of such compensation must also ensure that P realizes an appropriate return for its manufacturing efforts. Benefits projected with respect to such sales will be included for purposes of estimating S's, but not P's, RAB share.

Example 2. The facts are the same as in *Example 1* except that P and S agree to divide their interest in product Z based on site of manufacturing. P will have exclusive and perpetual rights in product Z manufactured in facilities owned by P. S will have exclu-

sive and perpetual rights to product Z manufactured in facilities owned by S. P and S agree that neither will license manufacturing rights in product Z to any related or unrelated party. Both P and S maintain books and records that allow production at all sites to be verified. Both own facilities that will manufacture product Z and the relative capacities of these sites are known. All facilities are currently operating at near capacity and are expected to continue to operate at near capacity when product Z enters production so that it will not be feasible to shift production between P's and S's facilities. P and S have no plans to build new facilities and the lead time required to plan and build a manufacturing facility precludes the possibility that P or S will build a new facility during the period for which sales of Product Z are expected. Based on these facts, this basis for the division of interests in Product Z is a division described in paragraph (b)(4)(iv) of this section. The basis for the division of interest is unambiguous and clearly defined and its use can be dependably verified. P and S both have non-overlapping, exclusive and perpetual rights in Product Z. The division of interest results in the participant's relative benefits being predictable with reasonable reliability.

Example 3. The facts are the same as in *Example 2* except that P's and S's manufacturing facilities are not expected to operate at full capacity when product Z enters production. Production of Product Z can be shifted at any time between sites owned by P and sites owned by S, although neither P nor S intends to shift production as a result of the agreement. The division of interests in Product Z between P and S based on manufacturing site is not a division described in paragraph (b)(4)(iv) of this section because their relative shares of benefits are not predictable with reasonable reliability. The fact that neither P nor S intends to shift production is irrelevant.

(5) *Treatment of certain arrangements as CSAs*—(i) *Situation in which Commissioner must treat arrangement as a CSA.* The Commissioner must apply the rules of this section to an arrangement among controlled taxpayers if the administrative requirements of paragraph (b)(2) of this section are met with respect to such arrangement and the controlled taxpayers reasonably concluded that such arrangement was a CSA meeting the requirements of paragraphs (b)(1), (3), and (4) of this section.

(ii) *Situation in which Commissioner may treat arrangement as a CSA.* For arrangements among controlled taxpayers not described in paragraph

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(b)(5)(i) of this section, the Commissioner may apply the provisions of this section if the Commissioner concludes that the administrative requirements of paragraph (b)(2) of this section are met, and, notwithstanding technical failure to meet the substantive requirements of paragraph (b)(1), (3), or (4) of this section, the rules of this section will provide the most reliable measure of an arm's length result. See § 1.482-1(c)(1) (the best method rule). For purposes of applying this paragraph (b)(5)(ii), any such arrangement shall be interpreted by reference to paragraph (k)(1)(iv) of this section.

(iii) *Examples.* The following examples illustrate the principles of this paragraph (b)(5). In the examples, assume that Companies P and S are both members of the same controlled group.

Example 1. (i) P owns the patent on a formula for a capsulated pain reliever, P-Cap. P reasonably anticipates, pending further research and experimentation, that the P-Cap formula could form the platform for a formula for P-Ves, an effervescent version of P-Cap. P also owns proprietary software that it reasonably anticipates to be critical to the research efforts. P and S execute a contract that purports to be a CSA by which they agree to proportionally share the costs and risks of developing a formula for P-Ves. The agreement reflects the various contractual requirements described in paragraph (k)(1) of this section and P and S comply with the documentation, accounting, and reporting requirements of paragraphs (k)(2) through (4) of this section. Both the patent rights for P-Cap and the software are reasonably anticipated to contribute to the development of P-Ves and therefore are platform contributions for which compensation is due from S as part of PCTs. Though P and S enter into and implement a PCT for the P-Cap patent rights that satisfies the arm's length standard, they fail to enter into a PCT for the software.

(ii) In this case, P and S have substantially complied with the contractual requirements of paragraph (k)(1) of this section and the documentation, accounting, and reporting requirements of paragraphs (k)(2) through (4) of this section and therefore have met the administrative requirements of paragraph (b)(2) of this section. However, because they did not enter into a PCT, as required under paragraphs (b)(1)(ii) and (b)(3) of this section, for the software that was reasonably anticipated to contribute to the development of P-Ves (see paragraph (c) of this section), they cannot reasonably conclude that their arrangement was a CSA. Accordingly, the

Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(iii) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and treat P and S as entering into a PCT for the software in accordance with the requirements of paragraph (b)(1)(ii) of this section, and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other sections of the 482 regulations to determine whether the arrangement reaches an arm's length result.

Example 2. The facts are the same as in *Example 1* except that P and S do enter into and implement a PCT for the software as required under this paragraph (b). The Commissioner determines that the PCT Payments for the software were not arm's length; nevertheless, under the facts and circumstances at the time they entered into the CSA and PCTs, P and S reasonably concluded their arrangement to be a CSA. Because P and S have met the requirements of paragraph (b)(2) of this section and reasonably concluded their arrangement is a CSA, pursuant to paragraph (b)(5)(i) of this section, the Commissioner must apply the rules of this section to their arrangement. Accordingly, the Commissioner treats the arrangement as a CSA and makes adjustments to the PCT Payments as appropriate under this section to achieve an arm's length result for the PCT for the software.

Example 3. (i) The facts are the same as in *Example 1* except that P and S do enter into a PCT for the software as required under this paragraph (b). The agreement entered into by P and S provides for a fixed consideration of \$50 million per year for four years, payable at the end of each year. This agreement satisfies the arm's length standard. However, S actually pays P consideration at the end of each year in the form of four annual royalties equal to two percent of sales. While such royalties at the time of the PCT were expected to be \$50 million per year, actual sales during the first year were less than anticipated and the first royalty payment was only \$25 million.

(ii) In this case, P and S failed to implement the terms of their agreement. Under these circumstances, P and S could not reasonably conclude that their arrangement was a CSA, as described in paragraph (b)(1) of this section. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of

this section to apply the rules of this section to their arrangement.

(iii) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other sections of the 482 regulations to determine whether the arrangement reaches an arm's length result.

Example 4. (i) The facts are the same as in *Example 1* except that P does not own proprietary software and P and S use a method for determining the arm's length amount of the PCT Payment for the P-Cap patent rights different from the method used in *Example 1*.

(ii) P and S determine that the arm's length amount of the PCT Payments for the P-Cap patent is \$10 million. However, the Commissioner determines the best method for determining the arm's length amount of the PCT Payments for the P-Cap patent rights and under such method the arm's length amount is \$100 million. To determine this \$10 million present value, P and S assumed a useful life of eight years for the platform contribution, because the P-Cap patent rights will expire after eight years. However, the P-Cap patent rights are expected to lead to benefits attributable to exploitation of the cost shared intangibles extending many years beyond the expiration of the P-Cap patent, because use of the P-Cap patent rights will let P and S bring P-Ves to market before the competition, and because P and S expect to apply for additional patents covering P-Ves, which would bar competitors from selling that product for many future years. The assumption by P and S of a useful life for the platform contribution that is less than the anticipated period of exploitation of the cost shared intangibles is contrary to paragraph (g)(2)(ii) of this section, and reduces the reliability of the method used by P and S.

(iii) The method used by P and S employs a declining royalty. The royalty starts at 8% of sales, based on an application of the CUT method in which the purported CUTs all involve licenses to manufacture and sell the current generation of P-Cap, and declines to 0% over eight years, declining by 1% each year. Such make-or-sell rights are fundamentally different from use of the P-Cap patent rights to generate a new product. This difference raises the issue of whether the make-or-sell rights are sufficiently comparable to the rights that are the subject of

the PCT Payment. See § 1.482-4(c). While a royalty rate for make-or-sell rights can form the basis for a reliable determination of an arm's length PCT Payment in the CUT-based implementation of the income method described in paragraph (g)(4) of this section, under that method such royalty rate does not decline to zero. Therefore, the use of a declining royalty rate based on an initial rate for make-or-sell rights further reduces the reliability of the method used by P and S.

(iv) Sales of the next-generation product are not anticipated until after seven years, at which point the royalty rate will have declined to 1%. The temporal mismatch between the period of the royalty rate decline and the period of exploitation raises further concerns about the method's reliability.

(v) For the reasons given in paragraphs (ii) through (iv) of this *Example 4*, the method used by P and S is so unreliable and so contrary to provisions of this section that P and S could not reasonably conclude that they had contracted to make arm's length PCT Payments as required by paragraphs (b)(1)(ii) and (b)(3) of this section, and thus could not reasonably conclude that their arrangement was a CSA. Accordingly, the Commissioner is not required under paragraph (b)(5)(i) of this section to apply the rules of this section to their arrangement.

(vi) Nevertheless, the arrangement between P and S closely resembles a CSA. If the Commissioner concludes that the rules of this section provide the most reliable measure of an arm's length result for such arrangement, then pursuant to paragraph (b)(5)(ii) of this section, the Commissioner may apply the rules of this section and make any appropriate allocations under paragraph (i) of this section. Alternatively, the Commissioner may conclude that the rules of this section do not provide the most reliable measure of an arm's length result. In such case, the arrangement would be analyzed under the methods under other section 482 regulations to determine whether the arrangement reaches an arm's length result.

(6) *Entity classification of CSAs.* See § 301.7701-1(c) of this chapter for the classification of CSAs for purposes of the Internal Revenue Code.

(c) *Platform contributions*—(1) *In general.* A platform contribution is any resource, capability, or right that a controlled participant has developed, maintained, or acquired externally to the intangible development activity (whether prior to or during the course of the CSA) that is reasonably anticipated to contribute to developing cost shared intangibles. The determination whether a resource, capability, or right

is reasonably anticipated to contribute to developing cost shared intangibles is ongoing and based on the best available information. Therefore, a resource, capability, or right reasonably determined not to be a platform contribution as of an earlier point in time, may be reasonably determined to be a platform contribution at a later point in time. The PCT obligation regarding a resource or capability or right once determined to be a platform contribution does not terminate merely because it may later be determined that such resource or capability or right has not contributed, and no longer is reasonably anticipated to contribute, to developing cost shared intangibles. Notwithstanding the other provisions of this paragraph (c), platform contributions do not include rights in land or depreciable tangible property, and do not include rights in other resources acquired by IDCs. See paragraph (d)(1) of this section.

(2) *Terms of platform contributions*—(i) *Presumed to be exclusive*. For purposes of a PCT, the PCT Payee's provision of a platform contribution is presumed to be exclusive. Thus, it is presumed that the platform resource, capability, or right is not reasonably anticipated to be committed to any business activities other than the CSA Activity, as defined in paragraph (j)(1)(i) of this section, whether carried out by the controlled participants, other controlled taxpayers, or uncontrolled taxpayers.

(ii) *Rebuttal of exclusivity*. The controlled participants may rebut the presumption set forth in paragraph (c)(2)(i) of this section to the satisfaction of the Commissioner. For example, if the platform resource is a research tool, then the controlled participants could rebut the presumption by establishing to the satisfaction of the Commissioner that, as of the date of the PCT, the tool is reasonably anticipated not only to contribute to the CSA Activity but also to be licensed to an uncontrolled taxpayer. In such case, the PCT Payments may need to be prorated as described in paragraph (c)(2)(iii) of this section.

(iii) *Proration of PCT Payments to the extent allocable to other business activities*—(A) *In general*. Some transfer pricing methods employed to determine

the arm's length amount of the PCT Payments do so by considering the overall value of the platform contributions as opposed to, for example, the value of the anticipated use of the platform contributions in the CSA Activity. Such a transfer pricing method is consistent with the presumption that the platform contribution is exclusive (that is, that the resources, capabilities or rights that are the subject of a platform contribution are reasonably anticipated to contribute only to the CSA Activity). See paragraph (c)(2)(i) (Terms of platform contributions—Presumed to be exclusive) of this section. The PCT Payments determined under such transfer pricing method may have to be prorated if the controlled participants can rebut the presumption that the platform contribution is exclusive to the satisfaction of the Commissioner as provided in paragraph (c)(2)(ii) of this section. In the case of a platform contribution that also contributes to lines of business of a PCT Payor that are not reasonably anticipated to involve exploitation of the cost shared intangibles, the need for explicit proration may in some cases be avoided through aggregation of transactions. See paragraph (g)(2)(iv) of this section (Aggregation of transactions).

(B) *Determining the proration of PCT Payments*. Proration will be done on a reasonable basis in proportion to the relative economic value, as of the date of the PCT, reasonably anticipated to be derived from the platform contribution by the CSA Activity as compared to the value reasonably anticipated to be derived from the platform contribution by other business activities. In the case of an aggregate valuation done under the principles of paragraph (g)(2)(iv) of this section that addresses payment for resources, capabilities, or rights used for business activities other than the CSA Activity (for example, the right to exploit an existing intangible without further development), the proration of the aggregate payments may have to reflect the economic value attributable to such resources, capabilities, or rights as well. For purposes of the best method rule under § 1.482-1(c), the reliability of the analysis under a method that requires proration pursuant to this paragraph is

reduced relative to the reliability of an analysis under a method that does not require proration.

(3) *Categorization of the PCT.* For purposes of §1.482-1(b)(2)(ii) and paragraph (a)(2) of this section, a PCT must be identified by the controlled participants as a particular type of transaction (for example, a license for royalty payments). See paragraph (k)(2)(ii)(H) of this section. Such designation must be consistent with the actual conduct of the controlled participants. If the conduct is consistent with different, economically equivalent types of transactions then the controlled participants may designate the PCT as being any of such types of transactions. If the controlled participants fail to make such designation in their documentation, the Commissioner may make a designation consistent with the principles of paragraph (k)(1)(iv) of this section.

(4) *Certain make-or-sell rights excluded*—(i) *In general.* Any right to exploit an existing resource, capability, or right without further development of such item, such as the right to make, replicate, license, or sell existing products, does not constitute a platform contribution to a CSA (and the arm's length compensation for such rights (make-or-sell rights) does not satisfy the compensation obligation under a PCT) unless exploitation without further development of such item is reasonably anticipated to contribute to developing or further developing a cost shared intangible.

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

Example 1. P and S, which are members of the same controlled group, execute a CSA. Under the CSA, P and S will bear their R&B shares of IDCs for developing the second generation of ABC, a computer software program. Prior to that arrangement, P had incurred substantial costs and risks to develop ABC. Concurrent with entering into the arrangement, P (as the licensor) executes a license with S (as the licensee) by which S may make and sell copies of the existing ABC. Such make-or-sell rights do not constitute a platform contribution to the CSA. The rules of §§1.482-1 and 1.482-4 through 1.482-6 must be applied to determine the arm's length consideration in connection with the make-or-sell licensing arrangement. In certain circumstances, this deter-

mination of the arm's length consideration may be done on an aggregate basis with the evaluation of compensation obligations pursuant to the PCTs entered into by P and S in connection with the CSA. See paragraph (g)(2)(iv) of this section.

Example 2. (i) P, a software company, has developed and currently exploits software program ABC. P and S enter into a CSA to develop future generations of ABC. The ABC source code is the platform on which future generations of ABC will be built and is therefore a platform contribution of P for which compensation is due from S pursuant to a PCT. Concurrent with entering into the CSA, P licenses to S the make-or-sell rights for the current version of ABC. P has entered into similar licenses with uncontrolled parties calling for sales-based royalty payments at a rate of 20%. The current version of ABC has an expected product life of three years. P and S enter into a contingent payment agreement to cover both the PCT Payments due from S for P's platform contribution and payments due from S for the make-or-sell license. Based on the uncontrolled make-or-sell licenses, P and S agree on a sales-based royalty rate of 20% in Year 1 that declines on a straight line basis to 0% over the 3 year product life of ABC.

(ii) The make-or-sell rights for the current version of ABC are not platform contributions, though paragraph (g)(2)(iv) of this section provides for the possibility that the most reliable determination of an arm's length charge for the platform contribution and the make-or-sell license may be one that values the two transactions in the aggregate. A contingent payment schedule based on the uncontrolled make-or-sell licenses may provide an arm's length charge for the separate make-or-sell license between P and S, provided the royalty rates in the uncontrolled licenses similarly decline, but as a measure of the aggregate PCT and licensing payments it does not account for the arm's length value of P's platform contributions which include the rights in the source code and future development rights in ABC.

Example 3. S is a controlled participant that owns Patent Q, which protects S's use of a research tool that is helpful in developing and testing new pharmaceutical compounds. The research tool, which is not itself such a compound, is used in the CSA Activity to develop such compounds. However, the CSA Activity is not anticipated to result in the further development of the research tool or in patents based on Patent Q. Although the right to use Patent Q is not anticipated to result in the further development of Patent Q or the technology that it protects, that right constitutes a platform contribution (as opposed to make-or-sell rights) because it is

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anticipated to contribute to the research activity to develop cost shared intangibles relating to pharmaceutical compounds covered by the CSA.

(5) *Examples.* The following examples illustrate the principles of this paragraph (c). In each example, Companies P and S are members of the same controlled group, and execute a CSA providing that each will have the exclusive right to exploit cost shared intangibles in its own territory. See paragraph (b)(4)(ii) of this section (Territorial based divisional interests).

Example 1. Company P has developed and currently markets version 1.0 of a new software application XYZ. Company P and Company S execute a CSA under which they will share the IDCs for developing future versions of XYZ. Version 1.0 is reasonably anticipated to contribute to the development of future versions of XYZ and therefore Company P's rights in version 1.0 constitute a platform contribution from Company P that must be compensated by Company S pursuant to a PCT. Pursuant to paragraph (c)(3) of this section, the controlled participants designate the platform contribution as a transfer of intangibles that would otherwise be governed by § 1.482-4, if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by § 1.482-4 as supplemented by paragraph (g) of this section. Absent a showing to the contrary by P and S, the platform contribution in this case is presumed to be the exclusive provision of the benefit of all rights in version 1.0, other than the rights described in paragraph (c)(4) of this section (Certain make-or-sell rights excluded). This includes the right to use version 1.0 for purposes of research and the exclusive right in S's territory to exploit any future products that incorporated the technology of version 1.0, and would cover a term extending as long as the controlled participants were to exploit future versions of XYZ or any other product based on the version 1.0 platform. The compensation obligation of Company S pursuant to the PCT will reflect the full value of the platform contribution, as limited by Company S's RAB share.

Example 2. Company P and Company S execute a CSA under which they will share the IDCs for developing Vaccine Z. Company P will commit to the project its research team that has successfully developed a number of other vaccines. The expertise and existing integration of the research team is a unique resource or capability of Company P which is reasonably anticipated to contribute to the

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development of Vaccine Z. Therefore, P's provision of the capabilities of the research team constitute a platform contribution for which compensation is due from Company S as part of a PCT. Pursuant to paragraph (c)(3) of this section, the controlled parties designate the platform contribution as a provision of services that would otherwise be governed by § 1.482-9(a) if entered into by controlled parties. Accordingly, pursuant to paragraph (a)(2) of this section, the applicable method for determining the arm's length value of the compensation obligation under the PCT between Company P and Company S will be governed by § 1.482-9(a) as supplemented by paragraph (g) of this section. Absent a showing to the contrary by P and S, the platform contribution in this case is presumed to be the exclusive provision of the benefits by Company P of its research team to the development of Vaccine Z. Because the IDCs include the ongoing compensation of the researchers, the compensation obligation under the PCT is only for the value of the commitment of the research team by Company P to the CSA's development efforts net of such researcher compensation. The value of the compensation obligation of Company S for the PCT will reflect the full value of the provision of services, as limited by Company S's RAB share.

(d) *Intangible development costs—(1) Determining whether costs are IDCs.* Costs included in IDCs are determined by reference to the scope of the intangible development activity (IDA).

(i) *Definition and scope of the IDA.* For purposes of this section, the IDA means the activity under the CSA of developing or attempting to develop reasonably anticipated cost shared intangibles. The scope of the IDA includes all of the controlled participants' activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost shared intangibles. The IDA cannot be described merely by a list of particular resources, capabilities, or rights that will be used in the CSA, because such a list would not identify reasonably anticipated cost shared intangibles. Also, the scope of the IDA may change as the nature or identity of the reasonably anticipated cost shared intangibles changes or the nature of the activities necessary for their development become clearer. For example, the relevance of certain ongoing work to developing reasonably anticipated cost shared intangibles or the need for additional work may only become clear over time.

(ii) *Reasonably anticipated cost shared intangible.* For purposes of this section, *reasonably anticipated cost shared intangible* means any intangible, within the meaning of § 1.482-4(b), that, at the applicable point in time, the controlled participants intend to develop under the CSA. Reasonably anticipated cost shared intangibles may change over the course of the CSA. The controlled participants may at any time change the reasonably anticipated cost shared intangibles but must document any such change pursuant to paragraph (k)(2)(ii)(A)(1) of this section. Removal of reasonably anticipated cost shared intangibles does not affect the controlled participants' interests in cost shared intangibles already developed under the CSA. In addition, the reasonably anticipated cost shared intangibles automatically expand to include the intended result of any further development of a cost shared intangible already developed under the CSA, or applications of such an intangible. However, the controlled participants may override this automatic expansion in a particular case if they separately remove specified further development of such intangible (or specified applications of such intangible) from the IDA, and document such separate removal pursuant to paragraph (k)(2)(ii)(A)(3) of this section.

(iii) *Costs included in IDCs.* For purposes of this section, *IDCs* mean all costs, in cash or in kind (including stock-based compensation, as described in paragraph (d)(3) of this section), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the IDA. Thus, IDCs include costs incurred in attempting to develop reasonably anticipated cost shared intangibles regardless of whether such costs ultimately lead to development of those intangibles, other intangibles developed unexpectedly, or no intangibles. IDCs shall also include the arm's length rental charge for the use of any land or depreciable tangible property (as determined under § 1.482-2(c) (Use of tangible property)) directly identified with, or reasonably allocable to, the

IDA. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not be conclusive regarding inclusion of costs in IDCs. IDCs do not include interest expense, foreign income taxes (as defined in § 1.901-2(a)), or domestic income taxes.

(iv) *Examples.* The following examples illustrate the principles of this paragraph (d)(1):

Example 1. A contract that purports to be a CSA provides that the IDA to which the agreement applies consists of all research and development activity conducted at laboratories A, B, and C but not at other facilities maintained by the controlled participants. The contract does not describe the reasonably anticipated cost shared intangibles with respect to which research and development is to be undertaken. The contract fails to meet the requirements set forth in paragraph (k)(1)(ii)(B) of this section because it fails to adequately describe the scope of the IDA to be undertaken.

Example 2. A contract that purports to be a CSA provides that the IDA to which the agreement applies consists of all research and development activity conducted by any of the controlled participants with the goal of developing a cure for a particular disease. Such a cure is thus a reasonably anticipated cost shared intangible. The contract also contains a provision that the IDA will exclude any activity that builds on the results of the controlled participants' prior research concerning Enzyme X even though such activity could reasonably be anticipated to contribute to developing such cure. The contract fails to meet the requirement set forth in paragraph (d)(1)(i) of this section that the scope of the IDA include all of the controlled participants' activities that could reasonably be anticipated to contribute to developing reasonably anticipated cost shared intangibles.

(2) *Allocation of costs.* If a particular cost is directly identified with, or reasonably allocable to, a function the results of which will benefit both the IDA and other business activities, the cost must be allocated on a reasonable basis between the IDA and such other business activities in proportion to the relative economic value that the IDA and such other business activities are anticipated to derive from such results.

(3) *Stock-based compensation—(i) In general.* 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 with the IDA.* The determination of whether stock-based compensation is directly identified with, or reasonably allocable to, the IDA 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 CSA and, at date of grant, is directly identified with, or reasonably allocable to, the IDA is included as an IDC 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)(3)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation IDC—(A) In general.* Except as otherwise provided in this paragraph (d)(3)(iii), the cost 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 IDC 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)(3)(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)(3)(iii)(A), an amount is treated as an allowable deduction of a foreign 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)(3)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(3)(ii) of this section, to constitute the grant of a new stock option not identified with, or reasonably allocable to, the IDA, 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)(3)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an IDC as of the date of the modification.

(4) *Expiration or termination of CSA.* Solely for purposes of this paragraph (d)(3)(iii)(A), if an item of stock-based compensation identified with, or reasonably allocable to, the IDA is not exercised during the term of a CSA, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the CSA, 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)(3)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an IDC as of the date of the expiration or termination of the CSA.

(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 CSA may elect to take into account all IDCs 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)(3)(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)(3)(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)(3)(iii)(B) is made by an explicit reference to the election in the written contract required by paragraph (k)(1) of this section or in a written amendment to the CSA entered into with the consent of the Commissioner

pursuant to paragraph (d)(3)(iii)(C) of this section. In the case of a CSA in existence on August 26, 2003, the election by written amendment to the CSA may be made without the consent of the Commissioner if such amendment is entered into 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.

(C) *Consistency.* Generally, all controlled participants in a CSA taking options on publicly traded stock into account under paragraph (d)(3)(ii), (d)(3)(iii)(A), or (d)(3)(iii)(B) of this section must use that same method of identification, measurement and timing for all options on publicly traded stock with respect to that CSA. 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 CSA must join in requests for the Commissioner's consent under this paragraph (d)(3)(iii)(C). Thus, for example, if the controlled participants make the election described in paragraph (d)(3)(iii)(B) of this section upon the formation of the CSA, 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)(3)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(3)(iii)(B)(4) of this section, the controlled participants may make the election described in paragraph (d)(3)(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.

(4) *IDC share.* A controlled participant's IDC share for a taxable year is equal to the controlled participant's cost contribution for the taxable year, divided by the sum of all IDCs for the

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taxable year. A controlled participant's cost contribution for a taxable year means all of the IDCs initially borne by the controlled participant, plus all of the CST Payments that the participant makes to other controlled participants, minus all of the CST Payments that the participant receives from other controlled participants.

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

Example 1. Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a better mousetrap. USS and FP share the costs of FP's R&D facility that will be exclusively dedicated to this research, the salaries of the researchers at the facility, and 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. Based on the facts and circumstances, the cost of the conference facility cannot be directly identified with, and is not reasonably allocable to, the IDA. In this case, the cost of the conference facility must be excluded from the amount of IDCs.

Example 2. U.S. parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop intangibles for producing a new device. USP and FS share the costs of an R&D facility, the salaries of the facility's researchers, and overhead costs attributable to the project. Although USP also incurs costs related to field testing of the device, USP does not include those costs in the IDCs that USP and FS will share under the CSA. The Commissioner may determine, based on the facts and circumstances, that the costs of field testing are IDCs that the controlled participants must share.

Example 3. U.S. parent (USP) and its foreign subsidiary (FS) enter into a CSA to develop a new process patent. USP assigns certain employees to perform solely R&D to develop a new mathematical algorithm to perform certain calculations. That algorithm will be used both to develop the new process patent and to develop a new design patent the development of which is outside the scope of the CSA. During years covered by the CSA, USP compensates such employees with cash salaries, stock-based compensation, or a combination of both. USP and FS anticipate that the economic value attributable to the R&D will be derived from the process patent and the design patent in a relative proportion of 75% and 25%, respectively. Applying the principles of paragraph (d)(2) of this section, 75% of the compensation of such employees must be allocated to the development of the new process patent and, thus, treated as IDCs. With respect to the cash salary compensation, the IDC is 75% of the face value of the cash. With respect to

the stock-based compensation, the IDC is 75% of the value of the stock-based compensation as determined under paragraph (d)(3)(iii) of this section.

Example 4. Foreign parent (FP) and its U.S. subsidiary (USS) enter into a CSA to develop a new computer source code. FP has an executive officer who oversees a research facility and employees dedicated solely to the IDA. The executive officer also oversees other research facilities and employees unrelated to the IDA, and performs certain corporate overhead functions. The full amount of the costs of the research facility and employees dedicated solely to the IDA can be directly identified with the IDA and, therefore, are IDCs. In addition, based on the executive officer's records of time worked on various matters, the controlled participants reasonably allocate 20% of the executive officer's compensation to supervision of the facility and employees dedicated to the IDA, 50% of the executive officer's compensation to supervision of the facilities and employees unrelated to the IDA, and 30% of the executive officer's compensation to corporate overhead functions. The controlled participants also reasonably determine that the results of the executive officer's corporate overhead functions yield equal economic benefit to the IDA and the other business activities of FP. Applying the principles of paragraph (d)(1) of this section, the executive officer's compensation allocated to supervising the facility and employees dedicated to the IDA (amounting to 20% of the executive officer's total compensation) must be treated as IDCs. Applying the principles of paragraph (d)(2) of this section, half of the executive officer's compensation allocated to corporate overhead functions (that is, half of 30% of the executive officer's total compensation), must be treated as IDCs. Therefore, a total of 35% (20% plus 15%) of the executive officer's total compensation must be treated as IDCs.

(e) *Reasonably anticipated benefits share—(1) Definition—(i) In general.* A controlled participant's share of reasonably anticipated benefits is equal to its reasonably anticipated benefits divided by the sum of the reasonably anticipated benefits, as defined in paragraph (j)(1)(i) of this section, of all the controlled participants. RAB shares must be updated to account for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the CSA. For purposes of determining RAB shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future,

of exploitation of the cost shared intangibles, and must reflect appropriate updates to take into account the most reliable data regarding past and projected future results available at such time. RAB shares determined for a particular purpose shall not be further updated for that purpose based on information not available at the time that determination needed to be made. For example, RAB shares determined in order to determine IDC shares for a particular taxable year (as set forth in paragraphs (b)(1)(i) and (d)(4) of this section) shall not be recomputed based on information not available at that time. Similarly, RAB shares determined for the purpose of using a particular method such as the acquisition price method (as set forth in paragraph (g)(5)(ii) of this section) to evaluate the arm's length amount charged in a PCT shall not be recomputed based on information not available at the date of that PCT. However, nothing in this paragraph (e)(1)(i) shall limit the Commissioner's use of subsequently available information for purposes of its allocation determinations in accordance with the provisions of paragraph (i) (Allocations by the Commissioner in connection with a CSA) of this section.

(ii) *Reliability.* A controlled participant's RAB share must be determined by using the most reliable estimate. 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 between the estimates. The following factors will be particularly relevant in determining the reliability of an estimate of RAB shares:

(A) The basis used for measuring benefits, as described in paragraph (e)(2)(ii) of this section.

(B) The projections used to estimate benefits, as described in paragraph (e)(2)(iii) of this section.

(iii) *Examples.* The following examples illustrate the principles of this paragraph (e)(1):

Example 1. (i) USP and FS plan to conduct research to develop Product Lines A and B. USP and FS reasonably anticipate respective benefits from Product Line A of 100X and 200X and respective benefits from Product Line B, respectively, of 300X and 400X. USP and FS thus reasonably anticipate combined benefits from Product Lines A and B of 400X and 600X, respectively.

(ii) USP and FS could enter into a separate CSA to develop Product Line A with respective RAB shares of 33½ percent and 66½ percent (reflecting a ratio of 100X to 200X), and into a separate CSA to develop Product Line B with respective RAB shares of 42½ percent and 57½ percent (reflecting a ratio of 300X to 400X). Alternatively, USP and FS could enter into a single CSA to develop both Product Lines A and B with respective RAB shares of 40 percent and 60 percent (in the ratio of 400X to 600X). If the separate CSAs are chosen, then any costs for activities that contribute to developing both Product Line A and Product Line B will constitute IDCs of the respective CSAs as required by paragraphs (d)(1) and (2) of this section.

Example 2. (i) USP, a US company, wholly owns foreign subsidiary, FS. USP and FS enter into a CSA at the start of Year 1. The CSA's total IDCs are \$100,000 in each year for Years 1 through 4. In Year 1, USP correctly estimates its RAB share as 50%, based on information available at the time, and therefore correctly computes \$50,000 as its cost contribution for Year 1.

(ii) In Year 4, USP correctly estimates its RAB share to be 70%, based on information available at the time and, therefore, correctly computes \$70,000 as its cost contribution for Year 4.

(iii) In Year 4, USP also files an amended return for Year 1 in which USP deducts a cost contribution of \$70,000, asserting that, for this purpose, it should revise its Year 1 estimated RAB share to 70% based on the information that is now available to it in Year 4. The Commissioner determines that USP is incorrect for two reasons. First, a RAB share determined for a particular purpose (here, to determine USP's IDC shares and thus USP's cost contributions in Year 1) should not be revised based on information not available to USP until Year 4. See paragraph (e)(1)(i) of this section. Second, more generally, USP is not permitted to file an amended return for this purpose under § 1.482-1(a)(3). Therefore, for both of these reasons, Commissioner adjusts USP's amended return for Year 1 by disallowing \$20,000 of the \$70,000 deduction.

(2) *Measure of benefits*—(i) *In general*. In order to estimate a controlled participant's RAB share, the amount of each controlled participant's reasonably anticipated benefits must be measured on a basis that is consistent for all such participants. See paragraph (e)(2)(ii)(E) *Example 9* of this section. If a controlled participant transfers a cost shared intangible to another controlled taxpayer, other than by way of a transfer described in paragraph (f) of this section, that controlled participant's benefits from the transferred intangible 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). Reasonably anticipated benefits are measured either on a direct basis, by reference to estimated benefits to be generated by the use of cost shared intangibles (generally based on additional revenues plus cost savings less any additional costs incurred), or on an indirect basis, by reference to certain measurements that reasonably can be assumed to relate to benefits to be generated. Such indirect bases of measurement of anticipated benefits are described in paragraph (e)(2)(ii) of this section. A controlled participant's reasonably anticipated benefits must be measured on the basis, whether direct or indirect, that most reliably determines RAB shares. In determining which of two bases of measurement 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 cost shared intangibles. See *Examples 4* and *7* of paragraph (e)(2)(ii)(E) of this section.

(ii) *Indirect bases for measuring anticipated benefits*. Indirect bases for meas-

uring anticipated benefits from participation in a CSA 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 cost shared intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will more reliably determine RAB shares 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 cost shared intangibles per unit of the item or items used, produced, or sold. This circumstance is most likely to arise when the cost shared 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 cost shared intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will more reliably determine RAB shares to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to cost shared intangibles per dollar of sales. This circumstance is most likely to arise if the costs of exploiting cost shared intangibles are not substantial relative to the revenues generated, or if the principal effect of using cost shared intangibles is to increase the controlled participants' revenues (for example, 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 RAB shares unless each controlled participant operates at the same market level (for example, manufacturing, distribution, etc.).

(C) *Operating profit*. Operating profit of each controlled participant from the activities in which cost shared intangibles are exploited, as determined before any expense (including amortization) on account of IDCs, may be used as an indirect basis for measuring anticipated benefits. This basis of measurement will more reliably determine

RAB shares to the extent that such profit is largely attributable to the use of cost shared intangibles, or if the share of profits attributable to the use of cost shared intangibles is expected to be similar for each controlled participant. This circumstance is most likely to arise when cost shared intangibles are closely associated with 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 revenue generated or net costs saved by the use of cost shared 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 additional revenue generated or net costs saved by the controlled participants from using the cost shared intangibles.

(E) *Examples.* The following examples illustrates this paragraph (e)(2)(ii):

Example 1. Controlled parties A and B enter into a CSA to develop product and process intangibles for already existing Product P. Without such intangibles, A and B would each reasonably anticipate revenue, in present value terms, of \$100M from sales of Product P until it becomes obsolete. With the intangibles, A and B each reasonably anticipate selling the same number of units each year, but reasonably anticipate that the price will be higher. Because the particular product intangible is more highly regarded in A's market, A reasonably anticipates an increase of \$20M in present value revenue from the product intangible, while B reasonably anticipates an increase of only \$10M in present value from the product intangible. Further, A and B each reasonably anticipate spending an additional amount equal to \$5M in present value in production costs to include the feature embodying the product intangible. Finally, A and B each reasonably anticipate saving an amount equal to \$2M in present value in production costs by using the process intangible. A and B reasonably anticipate no other economic effects from exploiting the cost shared intangibles. A's reasonably anticipated benefits from exploiting the cost shared intangibles

equal its reasonably anticipated increase in revenue (\$20M) plus its reasonably anticipated cost savings (\$2M) less its reasonably anticipated increased costs (\$5M), which equals \$17M. Similarly, B's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue (\$10M) plus its reasonably anticipated cost savings (\$2M) less its reasonably anticipated increased costs (\$5M), which equals \$7M. Thus A's reasonably anticipated benefits are \$17M and B's reasonably anticipated benefits are \$7M.

Example 2. 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 CSA 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 \$2 per unit of feedstock produced and rates for each are expected to remain similar in the future. The new process, if it is successful, will reduce the amount of electricity required by each company to produce a unit of the feedstock by 50%. Switching to the new process would not require FP or USS to incur significant investment or other costs. Therefore, the cost savings each company is expected to achieve after implementing the new process are \$1 per unit of feedstock produced. Under the CSA, 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 RAB shares and dividing the IDCs because each controlled participant is expected to have a similar \$1 (50% of current charge of \$2) decrease in costs per unit of the feedstock produced.

Example 3. The facts are the same as in *Example 2*, except that currently USS pays \$3 per unit of feedstock produced for electricity while FP pays \$6 per unit of feedstock produced. In this case, units produced is not the most reliable basis for measuring RAB shares and dividing the IDCs because the participants do not expect to have a similar decrease in costs per unit of the feedstock produced. The Commissioner determines that the most reliable measure of RAB shares may be based on units of the feedstock produced if FP's units are weighted relative to USS's units by a factor of 2. This reflects the fact that FP pays twice as much as USS for electricity and, therefore, FP's savings of \$3 per unit of the feedstock (50% reduction of current charge of \$6) would be twice USS's savings of \$1.50 per unit of feedstock (50% reduction of current charge of \$3) from any new process eventually developed.

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Example 4. The facts are the same as in *Example 3*, 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, USS would incur significant construction costs in order 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 RAB shares. In order to reliably determine RAB shares, the Commissioner measures the reasonably anticipated benefits of USS and FP on a direct basis. USS's reasonably anticipated benefits are its reasonably anticipated total savings in electricity costs, less its reasonably anticipated costs of adopting the new process. FS's reasonably anticipated benefits are its reasonably anticipated total savings in electricity costs.

Example 5. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA to develop new anesthetic drugs. USP obtains the right to market any resulting drugs in the United States and FS obtains the right to market any resulting drugs in the rest of the world. USP and FS determine RAB shares on the basis of their respective total anticipated operating profit from all drugs under development. USP anticipates that it will receive a much higher profit than FS per unit sold because the price of the drugs is not regulated in the United States, whereas the price of the drugs is regulated in many non-U.S. jurisdictions. In both controlled participants' territories, the anticipated operating profits are almost entirely attributable to the use of the cost shared intangibles. In this case, the controlled participants' basis for measuring RAB shares is the most reliable.

Example 6. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) manufacture and sell fertilizers. They enter into a CSA to develop a new pellet form of a common agricultural fertilizer that is currently available only in powder form. Under the CSA, 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 new form of fertilizer in 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 controlled 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. This price premium will be a similar premium per dollar of sales in each territory. 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 participants' basis for measuring RAB shares is the most reliable.

Example 7. The facts are the same as in *Example 6*, 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 RAB shares unless adjustments are made to account for the difference in market levels at which the sales occur.

Example 8. Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA 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 measure benefits based on the number of entry-level employees hired by each. Rather, they measure benefits based on compensation paid to the entry-level employees hired by each. In this case, the basis used for measuring RAB shares 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 9. U.S. Parent (USP), Foreign Subsidiary 1 (FS1), and Foreign Subsidiary 2 (FS2) enter into a CSA to develop computer software that each will market and install on customers' computer systems. The controlled participants measure benefits 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 controlled participant is not the most reliable because all of the benefits received by controlled participants are not taken into account. In order to reliably determine RAB 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 controlled participants' projected benefits from sales (for example, all controlled participants might measure their benefits on the basis of operating profit).

(iii) *Projections used to estimate benefits*—(A) *In general.* The reliability of an

estimate of RAB shares 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 activities under the CSA 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 cost shared 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 normally will be necessary to use the present value of the projected benefits to reliably determine RAB shares. See paragraph (g)(2)(v) of this section for best method considerations regarding discount rates used for this purpose. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of RAB shares. This circumstance is most likely to occur when the CSA is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the cost shared intangibles is unlikely to change, the cost shared intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Examples.* The following examples illustrate the principles of this paragraph (e)(2)(iii):

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA to develop a new car model. The controlled 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. The controlled participants determine RAB shares for each

year of 66⅔% for USS and 33⅓% for FP, based on projected total sales.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. In order to reflect USS's one-year lag in introducing new car models, a more reliable projection of each participant's RAB share 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 CSA to develop new and improved household cleaning products. Both controlled participants have sold household cleaning products for many years and have stable worldwide market shares. The products under development are unlikely to produce unusual profits for either controlled participant. The controlled participants determine RAB shares on the basis of each controlled participant's current sales of household cleaning products. In this case, the controlled participants' RAB 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 controlled participants' RAB shares are not reliably projected by current sales of cleaning products. FS's benefit projections should take into account its growth in market share.

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

(f) *Changes in participation under a CSA—(1) In general.* A change in participation under a CSA occurs when there is either a controlled transfer of interests or a capability variation. A change in participation requires arm's length consideration under paragraph (a)(3)(ii) of this section, and as more fully described in this paragraph (f).

(2) *Controlled transfer of interests.* A controlled transfer of interests occurs when a participant in a CSA transfers all or part of its interests in cost shared intangibles under the CSA in a

controlled transaction, and the transferee assumes the associated obligations under the CSA. For example, a change in the territorial based divisional interests or field of use based divisional interests, as described in paragraph (b)(4), is a controlled transfer of interests. After the controlled transfer of interests occurs, the CSA will still exist if at least two controlled participants still have interests in the cost shared intangibles. In such a case, the transferee will be treated as succeeding to the transferor's prior history under the CSA as pertains to the transferred interests, including the transferor's cost contributions, benefits derived, and PCT Payments attributable to such rights or obligations. A transfer that would otherwise constitute a controlled transfer of interests for purposes of this paragraph (f)(2) shall not constitute a controlled transfer of interests if it also constitutes a capability variation for purposes of paragraph (f)(3) of this section.

(3) *Capability variation.* A capability variation occurs when, in a CSA in which interests in cost shared intangibles are divided as described in paragraph (b)(4)(iv) of this section, the controlled participants' division of interests or their relative capabilities or capacities to benefit from the cost shared intangibles are materially altered. For purposes of paragraph (a)(3)(ii) of this section, a capability variation is considered to be a controlled transfer of interests in cost shared intangibles, in which any controlled participant whose RAB share decreases as a result of the capability variation is a transferor, and any controlled participant whose RAB share thus increases is the transferee of the interests in cost shared intangibles.

(4) *Arm's length consideration for a change in participation.* In the event of a change in participation, the arm's length amount of consideration from the transferee, under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6 and paragraph (a)(3)(ii) of this section, will be determined consistent with the reasonably anticipated incremental change in the returns to the transferee and transferor resulting from such change in participation. Such changes in returns will themselves depend on

the reasonably anticipated incremental changes in the benefits from exploiting the cost shared intangibles, IDCs borne, and PCT Payments (if any). However, any arm's length consideration required under this paragraph (f)(4) with respect to a capability variation shall be reduced as necessary to prevent duplication of an adjustment already performed under paragraph (i)(2)(ii)(A) of this section that resulted from the same capability variation. If an adjustment has been performed already under this paragraph (f)(4) with respect to a capability variation, then for purposes of any adjustment to be performed under paragraph (i)(2)(ii)(A) of this section, the controlled participants' projected benefit shares referred to in paragraph (i)(2)(ii)(A) of this section shall be considered to be the controlled participants' respective RAB shares after the capability variation occurred.

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

Example 1. X, Y, and Z are the only controlled participants in a CSA. The CSA divides interests in cost shared intangibles on a territorial basis as described in paragraph (b)(4)(ii) of this section. X is assigned the territories of the Americas, Y is assigned the territory of the UK and Australia, and Z is assigned the rest of the world. When the CSA is formed, X has a platform contribution T. Under the PCTs for T, Y and Z are each obligated to pay X royalties equal to five percent of their respective sales. Aside from T, there are no platform contributions. Two years after the formation of the CSA, Y transfers to Z its interest in cost shared intangibles relating to the UK territory, and the associated obligations, in a controlled transfer of interests described in paragraph (f)(2) of this section. At that time the reasonably anticipated benefits from exploiting cost shared intangibles in the UK have a present value of \$11M, the reasonably anticipated IDCs to be borne relating to the UK territory have a present value of \$3M, and the reasonably anticipated PCT Payments to be made to X relating to sales in the UK territory have a present value of \$2M. As arm's length consideration for the change in participation due to the controlled transfer of interests, Z must pay Y compensation with an anticipated present value of \$11M, less \$3M, less \$2M, which equals \$6M.

Example 2. As in *Example 2* of paragraph (b)(4)(v) of this section, companies P and S, both members of the same controlled group, enter into a CSA to develop product Z. P and

S agree to divide their interest in product Z based on site of manufacturing. P will have exclusive and perpetual rights in product Z manufactured in facilities owned by P. S will have exclusive and perpetual rights to product Z manufactured in facilities owned by S. P and S agree that neither will license manufacturing rights in product Z to any related or unrelated party. Both P and S maintain books and records that allow production at all sites to be verified. Both own facilities that will manufacture product Z and the relative capacities of these sites are known. All facilities are currently operating at near capacity and are expected to continue to operate at near capacity when product Z enters production so that it will not be feasible to shift production between P's and S's facilities. P and S have no plans to build new facilities and the lead time required to plan and build a manufacturing facility precludes the possibility that P or S will build a new facility during the period for which sales of Product Z are expected. When the CSA is formed, P has a platform contribution T. Under the PCT for T, S is obligated to pay P sales-based royalties according to a certain formula. Aside from T, there are no other platform contributions. Two years after the formation of the CSA, owing to a change in plans not reasonably foreseeable at the time the CSA was entered into, S acquires additional facilities F for the manufacture of Product Z. Such acquisition constitutes a capability variation described in paragraph (f)(3) of this section. Under this capability variation, S's RAB share increases from 50% to 60%. Accordingly, there is a compensable change in participation under paragraph (f)(3) of this section.

(g) *Supplemental guidance on methods applicable to PCTs—(1) In general.* This paragraph (g) provides supplemental guidance on applying the methods listed in this paragraph (g)(1) for purposes of evaluating the arm's length amount charged in a PCT. Each method will yield a value for the compensation obligation of each PCT Payor consistent with the product of the combined pre-tax value to all controlled participants of the platform contribution that is the subject of the PCT and the PCT Payor's RAB share. Each method must yield results consistent with measuring the value of a platform contribution by reference to the future income anticipated to be generated by the resulting cost shared intangibles. The methods are—

(i) The comparable uncontrolled transaction method described in § 1.482-4(c), or the comparable uncontrolled

services price method described in § 1.482-9(c), as further described in paragraph (g)(3) of this section;

(ii) The income method, described in paragraph (g)(4) of this section;

(iii) The acquisition price method, described in paragraph (g)(5) of this section;

(iv) The market capitalization method, described in paragraph (g)(6) of this section;

(v) The residual profit split method, described in paragraph (g)(7) of this section; and

(vi) Unspecified methods, described in paragraph (g)(8) of this section.

(2) *Best method analysis applicable for evaluation of a PCT pursuant to a CSA—(i) In general.* Each method must be applied in accordance with 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), except as those provisions are modified in this paragraph (g).

(ii) *Consistency with upfront contractual terms and risk allocation—the investor model—(A) In general.* Although all of the factors entering into a best method analysis described in § 1.482-1(c) and (d) must be considered, specific factors may be particularly relevant in the context of a CSA. In particular, the relative reliability of an application of any method depends on the degree of consistency of the analysis with the applicable contractual terms and allocation of risk under the CSA and this section among the controlled participants as of the date of the PCT, unless a change in such terms or allocation has been made in return for arm's length consideration. In this regard, a CSA involves an upfront division of the risks as to both reasonably anticipated obligations and reasonably anticipated benefits over the reasonably anticipated term of the CSA Activity. Accordingly, the relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that, as of the date of the PCT, each controlled participant's aggregate net investment in the CSA Activity (including platform contributions, operating contributions, as such term is defined in

paragraph (j)(1)(i) of this section, operating cost contributions, as such term is defined in paragraph (j)(1)(i) of this section, and cost contributions) is reasonably anticipated to earn a rate of return (which might be reflected in a discount rate used in applying a method) appropriate to the riskiness of the controlled participant's CSA Activity over the entire period of such CSA Activity. If the cost shared intangibles themselves are reasonably anticipated to contribute to developing other intangibles, then the period described in the preceding sentence includes the period, reasonably anticipated as of the date of the PCT, of developing and exploiting such indirectly benefited intangibles.

(B) *Example.* The following example illustrates the principles of this paragraph (g)(2)(ii):

Example. (i) P, a U.S. corporation, has developed a software program, DEF, which applies certain algorithms to reconstruct complete DNA sequences from partially-observed DNA sequences. S is a wholly-owned foreign subsidiary of P. On the first day of Year 1, P and S enter into a CSA to develop a new generation of genetic tests, GHI, based in part on the use of DEF. DEF is therefore a platform contribution of P for which compensation is due from S pursuant to a PCT. S makes no platform contributions to the CSA. Sales of GHI are projected to commence two years after the inception of the CSA and then to continue for eight more years. Based on industry experience, P and S are confident that GHI will be replaced by a new type of genetic testing based on technology unrelated to DEF or GHI and that, at that point, GHI will have no further value. P and S project that that replacement will occur at the end of Year 10.

(ii) For purposes of valuing the PCT for P's platform contribution of DEF to the CSA, P and S apply a type of residual profit split method that is not described in paragraph (g)(7) of this section and which, accordingly, constitutes an unspecified method. See paragraph (g)(7)(i) (last sentence) of this section. The principles of this paragraph (g)(2) apply to any method for valuing a PCT, including the unspecified method used by P and S.

(iii) Under the method employed by P and S, in each year, a portion of the income from sales of GHI in S's territory is allocated to certain routine contributions made by S. The residual of the profit or loss from GHI sales in S's territory after the routine allocation step is divided between P and S pro rata to their capital stocks allocable to S's territory. Each controlled participant's capital stock is computed by capitalizing, ap-

plying a capital growth factor to, and amortizing its historical expenditures regarding DEF allocable to S's territory (in the case of P), or its ongoing cost contributions towards developing GHI (in the case of S). The amortization of the capital stocks is effected on a straight-line basis over an assumed four-year life for the relevant expenditures. The capital stocks are grown using an assumed growth factor that P and S consider to be appropriate.

(iv) The assumption that all expenditures amortize on a straight-line basis over four years does not appropriately reflect the principle that as of the date of the PCT regarding DEF, every contribution to the development of GHI, including DEF, is reasonably anticipated to have value throughout the entire period of exploitation of GHI which is projected to continue through Year 10. Under this method as applied by P and S, the share of the residual profit in S's territory that is allocated to P as a PCT Payment from S will decrease every year. After Year 4, P's capital stock in DEF will necessarily be \$0, so that P will receive none of the residual profit or loss from GHI sales in S's territory after Year 4 as a PCT Payment.

(v) As a result of this limitation of the PCT Payments to be made by S, the anticipated return to S's aggregate investment in the CSA, over the whole period of S's CSA Activity, is at a rate that is significantly higher than the appropriate rate of return for S's CSA Activity (as determined by a reliable method). This discrepancy is not consistent with the investor model principle that S should anticipate a rate of return to its aggregate investment in the CSA, over the whole period of its CSA Activity, appropriate for the riskiness of its CSA Activity. The inconsistency of the method with the investor model materially lessens its reliability for purposes of a best method analysis. See § 1.482-1(c)(2)(ii)(B).

(iii) *Consistency of evaluation with realistic alternatives—(A) In general.* The relative reliability of an application of a method also depends on the degree of consistency of the analysis with the assumption that uncontrolled taxpayers dealing at arm's length would have evaluated the terms of the transaction, and only entered into such transaction, if no alternative is preferable. This condition is not met, therefore, where for any controlled participant the total anticipated present value of its income attributable to its entering into the CSA, as of the date of the PCT, is less than the total anticipated present value of its income that could be achieved through an alternative arrangement realistically available to

that controlled participant. In principle, this comparison is made on a post-tax basis but, in many cases, a comparison made on a pre-tax basis will yield equivalent results. See also paragraph (g)(2)(v)(B)(I) of this section (Discount rate variation between realistic alternatives).

(B) *Examples.* The following examples illustrate the principles of this paragraph (g)(2)(iii):

Example 1. (i) P, a corporation, and S, a wholly-owned subsidiary of P, enter into a CSA to develop a personal transportation device (the product). Under the arrangement, P will undertake all of the R&D, and manufacture and market the product in Country X. S will make CST Payments to P for its appropriate share of P's R&D costs, and manufacture and market the product in the rest of the world. P owns existing patents and trade secrets that are reasonably anticipated to contribute to the development of the product. Therefore the rights in the patents and trade secrets are platform contributions for which compensation is due from S as part of a PCT.

(ii) S's manufacturing and distribution activities under the CSA will be routine in nature, and identical to the activities it would undertake if it alternatively licensed the product from P.

(iii) Reasonably reliable estimates indicate that P could develop the product without assistance from S and license the product outside of Country X for a royalty of 20% of sales. Based on reliable financial projections that include all future development costs and licensing revenue that are allocable to the non-Country X market, and using a discount rate appropriate for the riskiness of P's role as a licensor (see paragraph (g)(2)(v) of this section), the post-tax present value of this licensing alternative to P for the non-Country X market (measured as of the date of the PCT) would be \$500 million. Thus, based on this realistic alternative, the anticipated post-tax present value under the CSA to P in the non-Country X market (measured as of the date of the PCT), taking into account anticipated development costs allocable to the non-Country X market, and anticipated CST Payments and PCT Payments from S, and using a discount rate appropriate for the riskiness of P's role as a participant in the CSA, should not be less than \$500 million.

Example 2. (i) The facts are the same as in *Example 1*, except that there are no reliable estimates of the value to P from the licensing alternative to the CSA. Further, reasonably reliable estimates indicate that an arm's length return for S's routine manufacturing and distribution activities is a 10% mark-up on total costs of goods sold plus op-

erating expenses related to those activities. Finally, the Commissioner determines that the respective activities undertaken by P and S (other than licensing payments, cost contributions, and PCT Payments) would be identical regardless of whether the arrangement was undertaken as a CSA (cost sharing alternative) or as a long-term licensing arrangement (licensing alternative). In particular, in both alternatives, P would perform all research activities and S would undertake routine manufacturing and distribution activities associated with its territory.

(ii) P undertakes an economic analysis that derives S's cost contributions under the CSA, based on reliable financial projections. Based on this and further economic analysis, P determines S's PCT Payment as a certain lump sum amount to be paid as of the date of the PCT (Date D).

(iii) Based on reliable financial projections that include S's cost contributions and that incorporate S's PCT Payment, as computed by P, and using a discount rate appropriate for the riskiness of S's role as a CSA participant (see paragraphs (g)(2)(v) and (4)(vi)(F) of this section), the anticipated post-tax net present value to S in the cost sharing alternative (measured as of Date D) is \$800 million. Further, based on these same reliable projections (but incorporating S's licensing payments instead of S's cost contributions and PCT Payment), and using a discount rate appropriate for the riskiness of S's role as a long-term licensee, the anticipated post-tax net present value to S in the licensing alternative (measured as of Date D) is \$100 million. Thus, S's anticipated post-tax net present value is \$700 million greater in the cost sharing alternative than in the licensing alternative. This result suggests that P's anticipated post-tax present value must be significantly less under the cost sharing alternative than under the licensing alternative. This means that the reliability of P's analysis as described in paragraph (ii) of this *Example 2* is reduced, because P would not be expected to enter into a CSA if its alternative of being a long-term licensor is preferable.

Example 3. (i) The facts are the same as in paragraphs (i) and (ii) of *Example 2*. In addition, based on reliable financial projections that include S's cost contributions and S's PCT Payment, and using a discount rate appropriate for the riskiness of S's role as a CSA participant, the anticipated post-tax net present value to S under the CSA (measured as of the date of the PCT) is \$50 million. Also, instead of entering the CSA, S has the realistic alternative of manufacturing and distributing product Z unrelated to the personal transportation device, with the same anticipated 10% mark-up on total costs that it would anticipate for its routine activities in *Example 2*. Under its realistic alternative,

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at a discount rate appropriate for the riskiness of S's role with respect to product Z, S anticipates a present value of \$100 million.

(ii) Because the lump sum PCT Payment made by S results in S having a considerably lower anticipated net present value than S could achieve through an alternative arrangement realistically available to it, the reliability of P's calculation of the lump sum PCT Payment is reduced.

(iv) *Aggregation of transactions.* The combined effect of multiple contemporaneous transactions, consisting either of multiple PCTs, or of one or more PCT and one or more other transactions in connection with a CSA that are not governed by this section (such as transactions involving cross operating contributions or make-or-sell rights), may require evaluation in accordance with the principles of aggregation described in §1.482-1(f)(2)(i). In such cases, it may be that the multiple transactions are reasonably anticipated, as of the date of the PCT(s), to be so interrelated that the method that provides the most reliable measure of an arm's length charge is a method under this section applied on an aggregate basis for the PCT(s) and other transactions. A section 482 adjustment may be made by comparing the aggregate arm's length charge so determined to the aggregate payments actually made for the multiple transactions. In such a case, it generally will not be necessary to allocate separately the aggregate arm's length charge as between various PCTs or as between PCTs and such other transactions. However, such an allocation may be necessary for other purposes, such as applying paragraph (i)(6) (Periodic adjustments) of this section. An aggregate determination of the arm's length charge for multiple transactions will often yield a payment for a controlled participant that is equal to the aggregate value of the platform contributions and other resources, capabilities, and rights covered by the multiple transactions multiplied by that controlled participant's RAB share. Because RAB shares only include benefits from cost shared intangibles, the reliability of an aggregate determination of payments for multiple transactions may be reduced to the extent that it includes transactions covering resources, capabilities, and rights for

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which the controlled participants' expected benefit shares differ substantially from their RAB shares.

(v) *Discount rate*—(A) *In general.* The best method analysis in connection with certain methods or forms of payment may depend on a rate or rates of return used to convert projected results of transactions to present value, or to otherwise convert monetary amounts at one or more points in time to equivalent amounts at a different point or points in time. For this purpose, a discount rate or rates should be used that most reliably reflect the market-correlated risks of activities or transactions and should be applied to the best estimates of the relevant projected results, based on all the information potentially available at the time for which the present value calculation is to be performed. Depending on the particular facts and circumstances, the market-correlated risk involved and thus, the discount rate, may differ among a company's various activities or transactions. Normally, discount rates are most reliably determined by reference to market information.

(B) *Considerations in best method analysis of discount rate*—(1) *Discount rate variation between realistic alternatives.* Realistic alternatives may involve varying risk exposure and, thus, may be more reliably evaluated using different discount rates. See paragraphs (g)(4)(i)(F) and (vi)(F) of this section. In some circumstances, a party may have less risk as a licensee of intangibles needed in its operations, and so require a lower discount rate, than it would have by entering into a CSA to develop such intangibles, which may involve the party's assumption of additional risk in funding its cost contributions to the IDA. Similarly, self-development of intangibles and licensing out may be riskier for the licensor, and so require a higher discount rate, than entering into a CSA to develop such intangibles, which would relieve the licensor of the obligation to fund a portion of the IDCs of the IDA.

(2) *Implied discount rates.* In some circumstances, the particular discount rate or rates used for certain activities or transactions logically imply that

certain other activities will have a particular discount rate or set of rates (implied discount rates). To the extent that an implied discount rate is inappropriate in light of the facts and circumstances, which may include reliable direct evidence of the appropriate discount rate applicable for such other activities, the reliability of any method is reduced where such method is based on the discount rates from which such an inappropriate implied discount rate is derived. See paragraphs (g)(4)(vi)(F)(2) and (g)(4)(viii), *Example 8* of this section.

(3) *Discount rate variation between forms of payment.* Certain forms of payment may involve different risks than others. For example, ordinarily a royalty computed on a profits base would be more volatile, and so require a higher discount rate to discount projected payments to present value, than a royalty computed on a sales base.

(4) *Post-tax rate.* In general, discount rate estimates that may be inferred from the operations of the capital markets are post-tax discount rates. Therefore, an analysis would in principle apply post-tax discount rates to income net of expense items including taxes (post-tax income). However, in certain circumstances the result of applying a post-tax discount rate to post-tax income is equivalent to the product of the result of applying a post-tax discount rate to income net of expense items other than taxes (pre-tax income), and the difference of one minus the tax rate (as defined in paragraph (j)(1)(i) of this section). Therefore, in such circumstances, calculation of pre-tax income, rather than post-tax income, may be sufficient. See, for example, paragraph (g)(4)(i)(G) of this section.

(C) *Example.* The following example illustrates the principles of this paragraph (g)(2)(v):

Example. (i) P and S form a CSA to develop intangible X, which will be used in product Y. P will develop X, and S will make CST Payments as its cost contributions. At the start of the CSA, P has a platform contribution, for which S commits to make a PCT Payment of 5% of its sales of product Y. As part of the evaluation of whether that PCT Payment is arm's length, the Commissioner considers whether P had a more favorable realistic alternative (see paragraph (g)(2)(iii) of

this section). Specifically, the Commissioner compares P's anticipated post-tax discounted present value of the financial projections under the CSA (taking into account S's PCT payment of 5% of its sale of product Y) with P's anticipated post-tax discounted present value of the financial projections under a reasonably available licensing alternative that consists of developing intangible X on its own and then licensing X to S or to an uncontrolled party similar to S. In undertaking the analysis, the Commissioner determines that, because it would be funding the entire development of the intangible, P undertakes greater risks in the licensing alternative than in the cost sharing alternative (in the cost sharing alternative P would be funding only part of the development of the intangible).

(ii) The Commissioner determines that, as between the two scenarios, all of the components of P's anticipated financial flows are identical, except for the CST and PCT Payments under the CSA, compared to the licensing payments under the licensing alternative. Accordingly, the Commissioner concludes that the differences in market-correlated risks between the two scenarios, and therefore the differences in discount rates between the two scenarios, relate to the differences in these components of the financial projections.

(vi) *Financial projections.* The reliability of an estimate of the value of a platform or operating contribution in connection with a PCT will often depend upon the reliability of projections used in making the estimate. Such projections should reflect the best estimates of the items projected (normally reflecting a probability weighted average of possible outcomes and thus also reflecting non-market-correlated risk). Projections necessary for this purpose may include a projection of sales, IDCs, costs of developing operating contributions, routine operating expenses, and costs of sales. Some method applications directly estimate projections of items attributable to separate development and exploitation by the controlled participants within their respective divisions. Other method applications indirectly estimate projections of items from the perspective of the controlled group as a whole, rather than from the perspective of a particular participant, and then apportion

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the items so estimated on some assumed basis. For example, in some applications, sales might be directly projected by division, but worldwide projections of other items such as operating expenses might be apportioned among divisions in the same ratio as the divisions' respective sales. Which approach is more reliable depends on which provides the most reliable measure of an arm's length result, considering the competing perspectives under the facts and circumstances in light of 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. For these purposes, projections that have been prepared for non-tax purposes are generally more reliable than projections that have been prepared solely for purposes of meeting the requirements in this paragraph (g).

(vii) *Accounting principles*—(A) *In general*. Allocations or other valuations done for accounting purposes may provide a useful starting point but will not be conclusive for purposes of the best method analysis in evaluating the arm's length charge in a PCT, particularly where the accounting treatment of an asset is inconsistent with its economic value.

(B) *Examples*. The following examples illustrate the principles of this paragraph (g)(2)(vii):

Example 1. (i) USP, a U.S. corporation and FSub, a wholly-owned foreign subsidiary of USP, enter into a CSA in Year 1 to develop software programs with application in the medical field. Company X is an uncontrolled software company located in the United States that is engaged in developing software programs that could significantly enhance the programs being developed by USP and FSub. Company X is still in a startup phase, so it has no currently exploitable products or marketing intangibles and its workforce consists of a team of software developers. Company X has negligible liabilities and tangible property. In Year 2, USP purchases Company X as part of an uncontrolled transaction in order to acquire its in-process technology and workforce for purposes of the development activities of the CSA. USP files a consolidated return that includes Company X. For accounting purposes, \$50 million of the \$100 million acquisition price is allocated to the in-process tech-

nology and workforce, and the residual \$50 million is allocated to goodwill.

(ii) The in-process technology and workforce of Company X acquired by USP are reasonably anticipated to contribute to developing cost shared intangibles and therefore the rights in the in-process technology and workforce of Company X are platform contributions for which FSub must compensate USP as part of a PCT. In determining whether to apply the acquisition price or another method for purposes of evaluating the arm's length charge in the PCT, relevant best method analysis considerations must be weighed in light of the general principles of paragraph (g)(2) of this section. The allocation for accounting purposes raises an issue as to the reliability of using the acquisition price method in this case because it suggests that a significant portion of the value of Company X's nonroutine contributions to USP's business activities is allocable to goodwill, which is often difficult to value reliably and which, depending on the facts and circumstances, might not be attributable to platform contributions that are to be compensated by PCTs. See paragraph (g)(5)(iv)(A) of this section.

(iii) Paragraph (g)(2)(vii)(A) of this section provides that accounting treatment may be a starting point, but is not determinative for purposes of assessing or applying methods to evaluate the arm's length charge in a PCT. The facts here reveal that Company X has nothing of economic value aside from its in-process technology and assembled workforce. The \$50 million of the acquisition price allocated to goodwill for accounting purposes, therefore, is economically attributable to either of, or both, the in-process technology and the workforce. That moots the potential issue under the acquisition price method of the reliability of valuation of assets not to be compensated by PCTs, since there are no such assets. Assuming the acquisition price method is otherwise the most reliable method, the aggregate value of Company X's in-process technology and workforce is the full acquisition price of \$100 million. Accordingly, the aggregate value of the arm's length PCT Payments due from FSub to USP for the platform contributions consisting of the rights in Company X's in-process technology and workforce will equal \$100 million multiplied by FSub's RAB share.

Example 2. (i) The facts are the same as in *Example 1*, except that Company X is a mature software business in the United States with a successful current generation of software that it markets under a recognized trademark, in addition to having the research team and new generation software in process that could significantly enhance the programs being developed under USP's and FSub's CSA. USP continues Company X's existing business and integrates the research team and the in-process technology into the

efforts under its CSA with FSub. For accounting purposes, the \$100 million price for acquiring Company X is allocated \$50 million to existing software and trademark, \$25 million to in-process technology and research workforce, and the residual \$25 million to goodwill and going concern value.

(ii) In this case an analysis of the facts indicates a likelihood that, consistent with the allocation under the accounting treatment (although not necessarily in the same amount), a significant amount of the nonroutine contributions to the USP's business activities consist of goodwill and going concern value economically attributable to the existing U.S. software business rather than to the platform contributions consisting of the rights in the in-process technology and research workforce. In addition, an analysis of the facts indicates that a significant amount of the nonroutine contributions to USP's business activities consist of the make-or-sell rights under the existing software and trademark, which are not platform contributions and might be difficult to value. Accordingly, further consideration must be given to the extent to which these circumstances reduce the relative reliability of the acquisition price method in comparison to other potentially applicable methods for evaluating the PCT Payment.

Example 3. (i) USP, a U.S. corporation, and FSub, a wholly-owned foreign subsidiary of USP, enter into a CSA in Year 1 to develop Product A. Company Y is an uncontrolled corporation that owns Technology X, which is critical to the development of Product A. Company Y currently markets Product B, which is dependent on Technology X. USP is solely interested in acquiring Technology X, but is only able to do so through the acquisition of Company Y in its entirety for \$200 million in an uncontrolled transaction in Year 2. For accounting purposes, the acquisition price is allocated as follows: \$120 million to Product B and the underlying Technology X, \$30 million to trademark and other marketing intangibles, and the residual \$50 million to goodwill and going concern value. After the acquisition of Company Y, Technology X is used to develop Product A. No other part of Company Y is used in any manner. Immediately after the acquisition, product B is discontinued, and, therefore, the accompanying marketing intangibles become worthless. None of the previous employees of Company Y is retained.

(ii) The Technology X of Company Y acquired by USP is reasonably anticipated to contribute to developing cost shared intangibles and is therefore a platform contribution for which FSub must compensate USP as part of a PCT. Although for accounting purposes a significant portion of the acquisition price of Company Y was allocated to items other than Technology X, the facts demonstrate that USP had no intention of using

and therefore placed no economic value on any part of Company Y other than Technology X. If USP was willing to pay \$200 million for Company Y solely for purposes of acquiring Technology X, then assuming the acquisition price method is otherwise the most reliable method, the value of Technology X is the full \$200 million acquisition price. Accordingly, the value of the arm's length PCT Payment due from FSub to USP for the platform contribution consisting of the rights in Technology X will equal the product of \$200 million and FSub's RAB share.

(viii) *Valuations of subsequent PCTs—(A) Date of subsequent PCT.* The date of a PCT may occur subsequent to the inception of the CSA. For example, an intangible initially developed outside the IDA may only subsequently become a platform contribution because that later time is the earliest date on which it is reasonably anticipated to contribute to developing cost shared intangibles within the IDA. In such case, the date of the PCT, and the analysis of the arm's length amount charged in the subsequent PCT, is as of such later time.

(B) *Best method analysis for subsequent PCT.* In cases where PCTs occur on different dates, the determination of the arm's length amount charged, respectively, in the prior and subsequent PCTs must be coordinated in a manner that provides the most reliable measure of an arm's length result. In some circumstances, a subsequent PCT may be reliably evaluated independently of other PCTs, as may be possible for example, under the acquisition price method. In other circumstances, the results of prior and subsequent PCTs may be interrelated and so a subsequent PCT may be most reliably evaluated under the residual profit split method of paragraph (g)(7) of this section. In those cases, for purposes of allocating the present value of nonroutine residual divisional profit or loss, and so determining the present value of the subsequent PCT Payments, in accordance with paragraph (g)(7)(iii)(C) of this section, the PCT Payor's interest in cost shared intangibles, both already developed and in process, are treated as additional PCT Payor operating contributions as of the date of the subsequent PCT.

(ix) *Arm's length range—(A) In general.* The guidance in § 1.482-1(e) regarding

determination of an arm's length range, as modified by this section, applies in evaluating the arm's length amount charged in a PCT under a transfer pricing method provided in this section (applicable method). Section 1.482-1(e)(2)(i) provides that 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 although use of more than one method may be appropriate for the purposes described in § 1.482-1(c)(2)(ii). The rules provided in § 1.482-1(e) and this section for determining an arm's length range shall not override the rules provided in paragraph (i)(6) of this section for periodic adjustments by the Commissioner. The provisions in paragraphs (g)(2)(ix)(C) and (D) of this section apply only to applicable methods that are based on two or more input parameters as described in paragraph (g)(2)(ix)(B) of this section. For an example of how the rules of this section for determining an arm's length range of PCT Payments are applied, see paragraph (g)(4)(viii) of this section.

(B) *Methods based on two or more input parameters.* An applicable method may determine PCT Payments based on calculations involving two or more parameters whose values depend on the facts and circumstances of the case (input parameters). For some input parameters (market-based input parameters), the value is most reliably determined by reference to data that derives from uncontrolled transactions (market data). For example, the value of the return to a controlled participant's routine contributions, as such term is defined in paragraph (j)(1)(i) of this section, to the CSA Activity (which value is used as an input parameter in the income method described in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the profit level of a company with rights, resources, and capabilities comparable to those routine contributions. See § 1.482-5. As another example, the value for the discount rate that reflects the riskiness of a controlled participant's role in the CSA (which value is used as an input parameter in the income method de-

scribed in paragraph (g)(4) of this section) may in some cases be most reliably determined by reference to the stock beta of a company whose overall risk is comparable to the riskiness of the controlled participant's role in the CSA.

(C) *Variable input parameters.* For some market-based input parameters (variable input parameters), the parameter's value is most reliably determined by considering two or more observations of market data that have, or with adjustment can be brought to, a similar reliability and comparability, as described in § 1.482-1(e)(2)(ii) (for example, profit levels or stock betas of two or more companies). See paragraph (g)(2)(ix)(B) of this section.

(D) *Determination of arm's length PCT Payment.* For purposes of applying this paragraph (g)(2)(ix), each input parameter is assigned a single most reliable value, unless it is a variable input parameter as described in paragraph (g)(2)(ix)(C) of this section. The determination of the arm's length payment depends on the number of variable input parameters.

(1) *No variable input parameters.* If there are no variable input parameters, the arm's length PCT Payment is a single value determined by using the single most reliable value determined for each input parameter.

(2) *One variable input parameter.* If there is exactly one variable input parameter, then under the applicable method, the arm's length range of PCT Payments is the interquartile range, as described in § 1.482-1(e)(2)(iii)(C), of the set of PCT Payment values calculated by selecting—

(i) Iteratively, the value of the variable input parameter that is based on each observation as described in paragraph (g)(2)(ix)(C) of this section; and

(ii) The single most reliable values for each other input parameter.

(3) *More than one variable input parameter.* If there are two or more variable input parameters, then under the applicable method, the arm's length range of PCT Payments is the interquartile range, as described in § 1.482-1(e)(2)(iii)(C), of the set of PCT Payment values calculated iteratively using every possible combination of permitted choices of values for the

input parameters. For input parameters other than a variable input parameter, the only such permitted choice is the single most reliable value. For variable input parameters, such permitted choices include any value that is—

(i) Based on one of the observations described in paragraph (g)(2)(ix)(C) of this section; and

(ii) Within the interquartile range (as described in § 1.482-1(e)(2)(iii)(C)) of the set of all values so based.

(E) *Adjustments.* Section 1.482-1(e)(3), applied as modified by this paragraph (g)(2)(ix), determines when the Commissioner may make an adjustment to a PCT Payment due to the taxpayer's results being outside the arm's length range. Adjustment will be to the median, as defined in § 1.482-1(e)(3). Thus, the Commissioner is not required to establish an arm's length range prior to making an allocation under section 482.

(x) *Valuation undertaken on a pre-tax basis.* PCT Payments in general may increase the PCT Payee's tax liability and decrease the PCT Payor's tax liability. The arm's length amount of a PCT Payment determined under the methods in this paragraph (g) is the value of the PCT Payment itself, without regard to such tax effects. Therefore, the methods under this section must be applied, with suitable adjustments if needed, to determine the PCT Payments on a pre-tax basis. See paragraphs (g)(2)(v)(B) and (4)(i)(G) of this section.

(3) *Comparable uncontrolled transaction method.* The comparable uncontrolled transaction (CUT) method described in § 1.482-4(c), and the comparable uncontrolled services price (CUSP) method described in § 1.482-9(c), may be applied to evaluate whether the amount charged in a PCT is arm's length by reference to the amount charged in a comparable uncontrolled transaction. Although all of the factors entering into a best method analysis described in § 1.482-1(c) and (d) must be considered, comparability and reliability under this method are particularly dependent on similarity of contractual terms, degree to which allocation of risks is proportional to reasonably anticipated benefits from exploiting the results of intangible development,

similar period of commitment as to the sharing of intangible development risks, and similar scope, uncertainty, and profit potential of the subject intangible development, including a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with this section. When applied in the manner described in § 1.482-4(c) or 1.482-9(c), the CUT or CUSP method will typically yield an arm's length total value for the platform contribution that is the subject of the PCT. That value must then be multiplied by each PCT Payor's respective RAB share in order to determine the arm's length PCT Payment due from each PCT Payor. The reliability of a CUT or CUSP that yields a value for the platform contribution only in the PCT Payor's division will be reduced to the extent that value is not consistent with the total worldwide value of the platform contribution multiplied by the PCT Payor's RAB share.

(4) *Income method—(i) In general—(A) Equating cost sharing and licensing alternatives.* The income method evaluates whether the amount charged in a PCT is arm's length by reference to a controlled participant's best realistic alternative to entering into a CSA. Under this method, the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT, of its cost sharing alternative of entering into a CSA equals the present value of its best realistic alternative. In general, the best realistic alternative of the PCT Payor to entering into the CSA would be to license intangibles to be developed by an uncontrolled licensor that undertakes the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Similarly, the best realistic alternative of the PCT Payee to entering into the CSA would be to undertake the commitment to bear the entire risk

of intangible development that would otherwise have been shared under the CSA and license the resulting intangibles to an uncontrolled licensee. Paragraphs (g)(4)(i)(B) through (vi) of this section describe specific applications of the income method, but do not exclude other possible applications of this method.

(B) *Cost sharing alternative.* The PCT Payor's cost sharing alternative corresponds to the actual CSA in accordance with this section, with the PCT Payor's obligation to make the PCT Payments to be determined and its commitment for the duration of the IDA to bear cost contributions.

(C) *Licensing alternative.* The licensing alternative is derived on the basis of a functional and risk analysis of the cost sharing alternative, but with a shift of the risk of cost contributions to the licensor. Accordingly, the PCT Payor's licensing alternative consists of entering into a license with an uncontrolled party, for a term extending for what would be the duration of the CSA Activity, to license the make-or-sell rights in to-be-developed resources, capabilities, or rights of the licensor. Under such license, the licensor would undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Apart from any difference in the allocation of the risks of the IDA, the licensing alternative should assume contractual provisions with regard to non-overlapping divisional intangible interests, and with regard to allocations of other risks, that are consistent with the actual CSA in accordance with this section. For example, the analysis under the licensing alternative should assume a similar allocation of the risks of any existing resources, capabilities, or rights, as well as of the risks of developing other resources, capabilities, or rights that would be reasonably anticipated to contribute to exploitation within the parties' divisions, that is consistent with the actual allocation of risks between the controlled participants as provided in the CSA in accordance with this section. Accordingly, the financial projections associated with the licensing and cost sharing alternatives are necessarily the same ex-

cept for the licensing payments to be made under the licensing alternative and the cost contributions and PCT Payments to be made under the CSA.

(D) *Only one controlled participant with nonroutine platform contributions.* This method involves only one of the controlled participants providing nonroutine platform contributions as the PCT Payee. For a method under which more than one controlled participant may be a PCT Payee, see the application of the residual profit method pursuant to paragraph (g)(7) of this section.

(E) *Income method payment forms.* The income method may be applied to determine PCT Payments in any form of payment (for example, lump sum, royalty on sales, or royalty on divisional profit). For converting to another form of payment, see generally paragraph (h) (Form of payment rules) of this section.

(F) *Discount rates appropriate to cost sharing and licensing alternatives.* The present value of the cost sharing and licensing alternatives, respectively, should be determined using the appropriate discount rates in accordance with paragraphs (g)(2)(v) and (g)(4)(vi) of this section. See, for example, § 1.482-7(g)(2)(v)(B)(1) (Discount rate variation between realistic alternatives). In circumstances where the market-correlated risks as between the cost sharing and licensing alternatives are not materially different, a reliable analysis may be possible by using the same discount rate with respect to both alternatives.

(G) *The effect of taxation on determining the arm's length amount.* (1) In principle, the present values of the cost sharing and licensing alternatives should be determined by applying post-tax discount rates to post-tax income (including the post-tax value to the controlled participant of the PCT Payments). If such approach is adopted, then the post-tax value of the PCT Payments must be appropriately adjusted in order to determine the arm's length amount of the PCT Payments on a pre-tax basis. See paragraph (g)(2)(x) of this section.

(2) In certain circumstances, post-tax income may be derived as the product

of the result of applying a post-tax discount rate to pre-tax income, and a factor equal to one minus the tax rate (as defined in (j)(1)(i)). See paragraph (g)(2)(v)(B) of this section.

(3) To the extent that a controlled participant's tax rate is not materially affected by whether it enters into the cost sharing or licensing alternative (or reliable adjustments may be made for varying tax rates), the factor (that is, one minus the tax rate) may be cancelled from both sides of the equation of the cost sharing and licensing alternative present values. Accordingly, in such circumstance it is sufficient to apply post-tax discount rates to projections of pre-tax income for the purpose of equating the cost sharing and licensing alternatives. The specific applications of the income method described in paragraphs (g)(4)(ii) through (iv) of this section and the examples set forth in paragraph (g)(4)(viii) of this section assume that a controlled participant's tax rate is not materially affected by whether it enters into the cost sharing or licensing alternative.

(ii) *Evaluation of PCT Payor's cost sharing alternative.* The present value of the PCT Payor's cost sharing alternative is the present value of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profits or losses, minus operating cost contributions, minus cost contributions, minus PCT Payments.

(iii) *Evaluation of PCT Payor's licensing alternative—(A) Evaluation based on CUT.* The present value of the PCT Payor's licensing alternative may be determined using the comparable uncontrolled transaction method, as described in § 1.482-4(c)(1) and (2). In this case, the present value of the PCT Payor's licensing alternative is the present value of the stream, over what would be the duration of the CSA Activity under the cost sharing alternative, of the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made under the cost sharing alternative, minus the licensing payments as determined under the comparable uncontrolled transaction method.

(B) *Evaluation based on CPM.* The present value of the PCT Payor's licensing alternative may be determined using the comparable profits method, as described in § 1.482-5. In this case, the present value of the licensing alternative is determined as in paragraph (g)(4)(iii)(A) of this section, except that the PCT Payor's licensing payments, as defined in paragraph (j)(1)(i) of this section, are determined in each period to equal the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost sharing alternative, minus operating cost contributions that would be made under the cost sharing alternative, minus market returns for routine contributions, as defined in paragraph (j)(1)(i) of this section. However, treatment of net operating contributions as operating cost contributions shall be coordinated with the treatment of other routine contributions pursuant to this paragraph so as to avoid duplicative market returns to such contributions.

(iv) *Lump sum payment form.* Where the form of PCT Payment is a lump sum as of the date of the PCT, then, based on paragraphs (g)(4)(i) through (iii) of this section, the PCT Payment equals the difference between—

(A) The present value, using the discount rate appropriate for the cost sharing alternative, of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profits or losses, minus cost contributions and operating cost contributions; and

(B) The present value of the licensing alternative.

(v) *Application of income method using differential income stream.* In some cases, the present value of an arm's length PCT Payment may be determined as the present value, discounted at the appropriate rate, of the PCT Payor's reasonably anticipated stream of additional positive or negative income over the duration of the CSA Activity that would result (before PCT Payments) from undertaking the cost sharing alternative rather than the licensing alternative (differential income stream). See *Example 9* of paragraph (g)(4)(viii) of this section.

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(vi) *Best method analysis considerations.* (A) *Coordination with § 1.482-1(c).* Whether results derived from 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). Thus, comparability and the quality of data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions, must be considered in determining whether this method provides the most reliable measure of an arm's length result.

(B) *Assumptions Concerning Tax Rates.* This method will be more reliable to the extent that the controlled participants' respective tax rates are not materially affected by whether they enter into the cost sharing or licensing alternative. Even if this assumption of invariant tax rates across alternatives does not hold, this method may still be reliable to the extent that reliable adjustments can be made to reflect the variation in tax rates.

(C) *Coordination with § 1.482-4(c)(2).* If the licensing alternative is evaluated using the comparable uncontrolled transactions method, as described in paragraph (g)(4)(iii)(A) of this section, any additional comparability and reliability considerations stated in § 1.482-4(c)(2) may apply.

(D) *Coordination with § 1.482-5(c).* If the licensing alternative is evaluated using the comparable profits method, as described in paragraph (g)(4)(iii)(B) of this section, any additional comparability and reliability considerations stated in § 1.482-5(c) may apply.

(E) *Certain Circumstances Concerning PCT Payor.* This method may be used even if the PCT Payor furnishes significant operating contributions, or commits to assume the risk of significant operating cost contributions, to the PCT Payor's division. However, in such a case, any comparable uncontrolled transactions described in paragraph (g)(4)(iii)(A) of this section, and any comparable transactions used under § 1.482-5(c) as described in paragraphs (g)(4)(iii)(B) of this section, should be consistent with such contributions (or reliable adjustments must be made for material differences).

(F) *Discount rates—(1) Reflection of similar risk profiles of cost sharing alternative and licensing alternative.* Because the financial projections associated with the licensing and cost sharing alternatives are the same, except for the licensing payments to be made under the licensing alternative and the cost contributions and PCT Payments to be made under the cost sharing alternative, the analysis of the risk profile and financial projections for a realistic alternative to the cost sharing alternative must be closely associated with the risk profile and financial projections associated with the cost sharing alternative, differing only in the treatment of licensing payments, cost contributions, and PCT Payments. When using discount rates in applying the income method, this means that even if different discount rates are warranted for the two alternatives, the risk profiles for the two discount rates are closely related to each other because the discount rate for the licensing alternative and the discount rate for the cost sharing alternative are both derived from the single probability-weighted financial projections associated with the CSA Activity. The difference, if any, in market-correlated risks between the licensing and cost sharing alternatives is due solely to the different effects on risks of the PCT Payor making licensing payments under the licensing alternative, on the one hand, and the PCT Payor making cost contributions and PCT Payments under the cost sharing alternative, on the other hand. That is, the difference in the risk profile between the two scenarios solely reflects the incremental risk, if any, associated with the cost contributions taken on by the PCT Payor in developing the cost shared intangible under the cost sharing alternative, and the difference, if any, in risk associated with the particular payment forms of the licensing payments and the PCT Payments, in light of the fact that the licensing payments in the licensing alternative are partially replaced by cost contributions and partially replaced by PCT Payments in the cost sharing alternative, each with its own payment form. An analysis under the income method that uses a different discount rate for the

cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the difference, if any, between the two discount rates reflects solely these differences in the risk profiles of these two alternatives. See, for example, paragraph (g)(2)(iii), *Example 2* of this section.

(2) *Use of differential income stream as a consideration in assessing the best method.* An analysis under the income method that uses a different discount rate for the cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the implied discount rate for the projected present value of the differential income stream is consistent with reliable direct evidence of the appropriate discount rate applicable for activities reasonably anticipated to generate an income stream with a similar risk profile to the differential income stream. Such differential income stream is defined as the stream of the reasonably anticipated residuals of the PCT Payor's licensing payments to be made under the licensing alternative, minus the PCT Payor's cost contributions to be made under the cost sharing alternative. See *Example 8* of paragraph (g)(4)(viii) of this section.

(vii) *Routine platform and operating contributions.* For purposes of this paragraph (g)(4), any routine contributions that are platform or operating contributions, the valuation and PCT Payments for which are determined and made independently of the income method, are treated similarly to cost contributions and operating cost contributions, respectively. Accordingly, wherever used in this paragraph (g)(4), the term "routine contributions" shall not include routine platform or operating contributions, and wherever the terms "cost contributions" and "operating cost contributions" appear in this paragraph, they shall include net routine platform contributions and net routine operating contributions, respectively. Net routine platform con-

tributions are the value of a controlled participant's total reasonably anticipated routine platform contributions, plus its reasonably anticipated PCT Payments to other controlled participants in respect of their routine platform contributions, minus the reasonably anticipated PCT Payments it is to receive from other controlled participants in respect of its routine platform contributions. Net routine operating contributions are the value of a controlled participant's total reasonably anticipated routine operating contributions, plus its reasonably anticipated arm's length compensation to other controlled participants in respect of their routine operating contributions, minus the reasonably anticipated arm's length compensation it is to receive from other controlled participants in respect of its routine operating contributions.

(viii) *Examples.* The following examples illustrate the principles of this paragraph (g)(4):

Example 1. (i) For simplicity of calculation in this *Example 1*, all financial flows are assumed to occur at the beginning of each period. USP, a software company, has developed version 1.0 of a new software application that it is currently marketing. In Year 1 USP enters into a CSA with its wholly-owned foreign subsidiary, FS, to develop future versions of the software application. Under the CSA, USP will have the rights to exploit the future versions in the United States, and FS will have the rights to exploit them in the rest of the world. The future rights in version 1.0, and USP's development team, are reasonably anticipated to contribute to the development of future versions and therefore the rights in version 1.0 and the research and development team are platform contributions for which compensation is due from FS as part of a PCT. USP does not transfer the current exploitation rights in version 1.0 to FS. FS will not perform any research or development activities and does not furnish any platform contributions nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of version 1.0 or future versions of the software.

(ii) FS undertakes financial projections in its territory of the CSA:

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(1) Year	(2) Sales	(3) Operating costs	(4) Cost contributions	(5) Operating income under cost sharing alternative (excluding PCT)
1	0	0	50	-50
2	0	0	50	-50
3	200	100	50	50
4	400	200	50	150
5	600	300	60	240
6	650	325	65	260
7	700	350	70	280
8	750	375	75	300
9	750	375	75	300
10	675	338	68	269
11	608	304	61	243
12	547	273	55	219
13	410	205	41	164
14	308	154	31	123
15	231	115	23	93

FS anticipates that activity on this application will cease after Year 15. The application was derived from software developed by Company Q, an uncontrolled party. FS has a license under Company Q's copyright, but that license expires after Year 15 and will not be renewed.

(iii) In evaluating the cost sharing alternative, FS concludes that the cost sharing alternative represents a riskier alternative for FS than the licensing alternative because, in cost sharing, FS will take on the additional risks associated with cost contributions. Taking this difference into account, FS concludes that the appropriate discount rate to apply in assessing the licensing alternative, based on discount rates

of comparable uncontrolled companies undertaking comparable licensing transactions, would be 13% per year, whereas the appropriate discount rate to apply in assessing the cost sharing alternative would be 15% per year. FS determines that the arm's length rate USP would have charged an uncontrolled licensee for a license of future versions of the software (if USP had further developed version 1.0 on its own) is 35% of the sales price, as determined under the CUT method in § 1.482-4(c). FS also determines that the tax rate applicable to it will be the same in the licensing alternative as in the CSA. Accordingly, the financial projections associated with the licensing alternative are:

(6) Year	(7) Sales	(8) Operating costs	(9) Licensing payments	(10) Operating income under licensing alternative	(11) Operating income under cost sharing alternative minus operating income under licensing alternative
1	0	0	0	0	-50
2	0	0	0	0	-50
3	200	100	70	30	20
4	400	200	140	60	90
5	600	300	210	90	150
6	650	325	228	97	163
7	700	350	245	105	175
8	750	375	263	112	188
9	750	375	263	112	188
10	675	338	236	101	168
11	608	304	213	91	152
12	547	273	191	83	136
13	410	205	144	61	103
14	308	154	108	46	77
15	231	115	81	35	58

(iv) Based on these projections and applying the appropriate discount rate, FS determines that under the cost sharing alternative, the present value of the stream of residuals of its anticipated divisional profits, reduced by the anticipated operating cost contributions and cost contributions, but not reduced by any PCT Payments (that is, the stream of anticipated operating income as shown in column 5) would be \$889 million. Under the licensing alternative, the present value of the stream of residuals of its anticipated divisional profits and losses minus the operating cost contributions (that is, the stream of anticipated operating income before licensing payments, which is the present value of column 7 reduced by column 8) would be \$1,419 billion, and the present value of the licensing payments would be \$994 million. Therefore, the total value of the licensing alternative would be \$425 million. In order for the present value of the cost sharing alternative to equal the present value of the licensing alternative, the present value of the PCT Payments must equal \$464 million. Therefore, the taxpayer makes and reports PCT Payments with a present value of \$464 million.

Example 2. Arm's length range. (i) The facts are the same as in *Example 1*. The Commissioner accepts the financial projections undertaken by FS. Further, the Commissioner determines that the licensing discount rate and the CUT licensing rate are most reliably determined by reference to comparable uncontrolled discount rates and license rates, respectively. The observations that are in

the interquartile range of the respective input parameters (see paragraph (g)(2)(ix) of this section) are as follows:

Observations that are within interquartile range	Comparable uncontrolled discount rate
1	11%
2	12
3 (Median)	13
4	15
5	17

Observations that are within interquartile range	Comparable uncontrolled licensing rate
1	30%
2	32
3 (Median)	35
4	37
5	40

(ii) Following the principles of paragraph (g)(2)(ix) of this section, the Commissioner undertakes 25 different applications of the income method, using each combination of the discount rate and licensing rate parameters. In undertaking this analysis, the Commissioner assumes that the ratio of the median discount rate for the cost sharing alternative to the median discount rate for the licensing alternative (that is, 15% to 13%) is maintained. The results of the 25 applications of the income method, sorted in ascending order of calculated present value of the PCT Payment, are as follows:

INCOME METHOD APPLICATION NUMBER::	Comparable uncontrolled licensing discount rate	Comparable uncontrolled CSA discount rate	Comparable uncontrolled licensing rate	Calculated lump sum PCT payment	Interquartile range of PCT payments
1	17%	19.6%	30%	217	
2	17	19.6	32	263	
3	15	17.3	30	264	
4	15	17.3	32	315	
5	13	15	30	321	
6	17	19.6	35	331	
7	12	13.8	30	354	LQ = 354
8	17	19.6	37	376	
9	13	15	32	378	
10	11	12.7	30	391	
11	15	17.3	35	391	
12	12	13.8	32	415	
13	15	17.3	37	442	Median = 442
14	17	19.6	40	444	
15	11	12.7	32	455	
16	13	15	35	464	
17	12	13.8	35	505	
18	15	17.3	40	517	
19	13	15	37	520	UQ = 520
20	11	12.7	35	551	
21	12	13.8	37	566	
22	13	15	40	605	
23	11	12.7	37	615	
24	12	13.8	40	655	
25	11	12.7	40	710	

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(iii) Accordingly, the Commissioner determines that a taxpayer will not be subject to adjustment if its initial (ex ante) determination of the present value of PCT Payments is between \$354 million and \$520 million (the lower and upper quartile results as shown in the last column). Because FS's determination of the present value of the PCT Payments, \$464 million, is within the interquartile range, no adjustments are warranted.

Example 3. (i) For simplicity of calculation in this *Example 3*, all financial flows are assumed to occur at the beginning of each period. USP, a U.S. software company, has developed version 1.0 of a new software application, employed to store and retrieve complex data sets in certain types of storage media. Version 1.0 is currently being marketed. In Year 1, USP enters into a CSA with its wholly-owned foreign subsidiary, FS, to develop future versions of the software application. Under the CSA, USP will have the exclusive rights to exploit the future versions in the U.S., and FS will have the exclusive rights to exploit them in the rest of the world. USP's rights in version 1.0, and its development team, are reasonably anticipated to contribute to the development of future versions of the software application and, therefore, the rights in version 1.0 are platform contributions for which compensation is due from FS as part of a PCT. USP also transfers the current exploitation rights in version 1.0 to FS and the arm's length amount of the compensation for such transfer is determined in the aggregate with the arm's length PCT Payments in this *Example 3*. FS does not furnish any platform contributions to the CSA nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of version 1.0 or future versions of the software. It is reasonably anticipated that FS will have gross sales of \$1000X in its territory for 5 years attributable to its exploitation of version 1.0 and the cost shared intangibles, after which time the software application will be rendered obsolete and unmarketable by the obsolescence of the storage medium technology to which it relates. FS's costs reasonably attributable to the CSA, other than cost contributions and operating cost contributions, are anticipated to be \$250X per year. Certain operating cost contributions that will be borne by FS are reasonably anticipated to equal \$200X per annum for 5 years. In addition, FS is reasonably anticipated to pay cost contributions of \$200X per year as a controlled participant in the CSA.

(ii) FS concludes that its realistic alternative would be to license software from an uncontrolled licensor that would undertake the commitment to bear the entire risk of software development. Applying CPM using the profit levels experienced by uncontrolled licensees with contractual provisions and allocations of risk that are comparable to

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those of FS's licensing alternative, FS determines that it could, as a licensee, reasonably expect a (pre-tax) routine return equal to 14% of gross sales or \$140X per year for 5 years. The remaining net revenue would be paid to the uncontrolled licensor as a license fee of \$410X per year. FS determines that the discount rate that would be applied to determine the present value of income and costs attributable to its participation in the licensing alternative would be 12.5% as compared to the 15% discount rate that would be applicable in determining the present value of the net income attributable to its participation in the CSA (reflecting the increased risk borne by FS in bearing a share of the R & D costs in the cost sharing alternative). FS also determines that the tax rate applicable to it will be the same in the licensing alternative as in the CSA.

(iii) On these facts, the present value to FS of entering into the cost sharing alternative equals the present value of the annual divisional profits (\$1,000X minus \$250X) minus operating cost contributions (\$200X) minus cost contributions (\$200X) minus PCT Payments, determined over 5 years by discounting at a discount rate of 15%. Thus, the present value of the residuals, prior to subtracting the present value of the PCT Payments, is \$1349X.

(iv) On these facts, the present value to FS of entering into the licensing alternative would be \$561X determined by discounting, over 5 years, annual divisional profits (\$1,000X minus \$250X) minus operating cost contributions (\$200X) and licensing payments (\$410X) at a discount rate of 12.5% per annum. The present value of the cost sharing alternative must also equal \$561X but equals \$1349X prior to subtracting the present value of the PCT Payments. Consequently, the PCT Payments must have a present value of \$788X.

Example 4. Pre-tax PCT Payment derived from post-tax information. (i) For simplicity of calculation in this *Example 4*, it is assumed that all payments are made at the end of each year. Domestic controlled participant USP has developed a technology, Z, that it would like to exploit for three years in a CSA. USP enters into a CSA with its wholly-owned foreign subsidiary, FS, that provides for PCT Payments from FS to USP with respect to USP's platform contribution to the CSA of Z in the form of three annual installment payments due from FS to USP on the last day of each of the first three years of the CSA. FS makes no platform contributions to the CSA. Prior to entering into the CSA, FS considers that it has the realistic alternative available to it of licensing Z from USP rather than entering into a CSA with USP to further develop Z for three years.

(ii) FS undertakes financial projections for both the licensing and cost sharing alternatives for exploitation of Z in its territory

of the CSA. These projections are set forth in the following tables. The example assumes that there is a reasonably anticipated effective tax rate of 25% in each of years 1 through 3 under both the licensing and cost

sharing alternatives. FS determines that the appropriate post-tax discount rate under the licensing alternative is 12.5%, and that the appropriate post-tax discount rate under the cost sharing alternative is 15%.

Licensing alternative	Present value (12.5% DR)	Year 1	Year 2	Year 3
(1) Sales .....	.....	\$1000	\$1100	\$1210
(2) License Fee .....	.....	400	440	484
(3) Operating costs .....	.....	500	550	605
(4) Operating Income	\$261	100	110	121
(5) Tax (25%) .....	.....	25	28	30
(6) Post-tax income	\$196	\$75	\$82	\$91
Cost sharing alternative	Present value (15% DR)	Year 1	Year 2	Year 3
(7) Sales .....	.....	\$1000	\$1100	\$1210
(8) Cost Contributions .....	.....	200	220	242
(9) PCT Payments	D	A	B	C
(10) Operating costs .....	.....	500	550	605
(11) Operating income excluding PCT	\$749	300	330	363
(12) Operating income	H	E	F	G
(13) Tax .....	.....	.....	.....	.....
(14) Post-tax income excluding PCT	\$562	\$225	\$248	\$272
(15) Post-tax income	L	I	J	K

(iii) Under paragraph (g)(4) of this section, the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT of its cost sharing alternative of entering into a CSA equals the present value of its best realistic alternative. This requires that L, the present value of the post-tax income under the CSA, equals the present value of the post-tax income under the licensing alternative, or \$196.

(iv) FS determines that PCT Payments for Z should be \$196 in Year 1 (A), \$215 in Year 2 (B), and \$236 in Year 3 (C). By using these amounts for A, B, and C in the table above, FS is able to derive the values of E, F, G, I, J, and K in the table above. Based on these PCT Payments for Z, the post-tax income will be \$78 in Year 1 (I), \$86 in Year 2 (J), and \$95 in Year 3 (K). When this post-tax income stream is discounted at the appropriate rate for the cost sharing alternative (15%), the net present value is \$196 (L). The present value of the PCT Payments, when discounted at the appropriate post-tax rate, is \$488 (D).

(v) The Commissioner undertakes an audit of the PCT Payments made by FS to USP for Z in Years 1 through 3. The Commissioner concludes that the PCT Payments for Z are arm's length in accordance with this paragraph (g)(4).

Example 5. Pre-tax PCT Payment derived from post-tax information. (i) The facts are the same as in paragraphs (i) and (ii) of *Example 4*. In addition, under this paragraph (g)(4), the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT of its cost sharing alternative

equals the present value of its best realistic alternative. This requires that L, the present value of the post-tax income under the CSA, equals the present value of the post-tax income under the licensing alternative, or \$196.

(ii) FS determines that the post-tax present value of the cost sharing alternative (excluding PCT Payments) is \$562. The post-tax present value of the licensing alternative is \$196. Accordingly, payments with a post-tax present value of \$366 are required.

(iii) The Commissioner undertakes an audit of the PCT Payments made by FS to USP for Z in Years 1 through 3. In correspondence to the Commissioner, USP maintains that the arm's length PCT Payment for Z should have a present value of \$366 (D).

(iv) The Commissioner considers that if FS makes PCT Payments for Z with a present value of \$366, then the post-tax present value under the CSA (considering the deductibility of the PCT Payments) will be \$287, substantially higher than the post-tax present value of the licensing arrangement, \$196. The Commissioner determines that, under the specific facts and assumptions of this example, the present value of the post-tax payments may be grossed up by a factor of (one minus the tax rate), resulting in a present value of pre-tax payments of \$488. Accordingly, FS must make yearly PCT Payments (A, B, and C) such that the present value of the Payments is \$488 (D). (When FS's post-tax income after these PCT Payments for Z is discounted at the appropriate rate for the cost sharing alternative (15%), the net present value is \$196 (L), which is equal to the present value of post-tax income under the

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licensing alternative.) The Commissioner concludes that the calculations that it has made for the PCT Payments for Z are arm's length in accordance with this paragraph (g)(4) and, accordingly, makes the appropriate adjustments to USP's income tax return to account for the gross-up required by paragraph (g)(2)(x) of this section.

Example 6. Pre-tax PCT Payment derived from pre-tax information. (i) The facts are the same as in paragraphs (i) and (ii) of *Example 4*. In addition, under paragraph (g)(4) of this section, the arm's length charge for a PCT Payment will be an amount such that a controlled participant's present value, as of the date of the PCT of its cost sharing alternative of entering into a CSA equals the present value of its best realistic alternative. This requires that "L," the present value of the post-tax income under the CSA, equals the present value of the post-tax income under the licensing alternative, or \$196.

(ii) Under the specific facts and assumptions of this *Example 6* (see paragraph (g)(4)(i)(G) of this section), and using the same (post-tax) discount rates as in *Example 4*, the present value of pre-tax income under the licensing alternative (that is, the operating income) is \$261, and the present value of pre-tax income under the cost sharing alternative (excluding PCT Payments) is \$749. Accordingly, FS determines that its PCT Payments for Z should have a present value equal to the difference between the two, or \$488 (D). Such PCT Payments for Z result in a present value of post-tax income under the cost sharing alternative of \$196 (L), which is equal to the present value of post-tax income under the licensing alternative.

(iii) The Commissioner undertakes an audit of the PCT Payments for Z made by FS to USP in Years 1 through 3. The Commissioner concludes that the PCT Payments for Z are arm's length in accordance with this paragraph (g)(4).

Example 7. Application of income method with a terminal value calculation. (i) For simplicity of calculation in this *Example 7*, all financial flows are assumed to occur at the beginning of each period. USP's research and development team, Q, has developed a technology, Z, for which it has several applications on the market now and several planned for release at future dates. In Year 1, USP, enters into a CSA with its wholly-owned subsidiary, FS, to develop future applications of Z. Under the CSA, USP will have the rights to further develop and exploit the future applications of Z in the United States, and FS will have the rights to further develop and exploit the future applications of Z in the rest of the world. Both Q and the rights to further develop and exploit future applications of Z are reasonably anticipated to contribute to the development of future applications of Z. Therefore, both Q and the rights to further develop and exploit the future applications

of Z are platform contributions for which compensation is due from FS to USP as part of a PCT. USP does not transfer the current exploitation rights for current applications of Z to FS. FS will not perform any research or development activities on Z and does not furnish any platform contributions to the CSA, nor does it control any operating intangibles at the inception of the CSA that would be relevant to the exploitation of either current or future applications of Z.

(ii) At the outset of the CSA, FS undertakes an analysis of the PCTs involving Q and the rights with respect to Z in order to determine the arm's length PCT Payments owing from FS to USP under the CSA. In that evaluation, FS concludes that the cost sharing alternative represents a riskier alternative for FS than the licensing alternative. FS further concludes that the appropriate discount rate to apply in assessing the licensing alternative, based on discount rates of comparable uncontrolled companies undertaking comparable licensing transactions, would be 13% per annum, whereas the appropriate discount rate to apply in assessing the cost sharing alternative would be 14% per annum. FS undertakes financial projections and anticipates making \$100 million in sales during the first two years of the CSA in its territory with sales in Years 3 through 8 increasing to \$200 million, \$400 million, \$600 million, \$650 million, \$700 million, and \$750 million, respectively. After Year 8, FS expects its sales of all products based upon exploitation of Z in the rest of the world to grow at 3% per annum for the future. FS and USP do not anticipate cessation of the CSA Activity with respect to Z at any determinable date. FS anticipates that its manufacturing and distribution costs for exploiting Z (including its operating cost contributions), will equal 60% of gross sales of Z from Year 1 onwards, and anticipates its cost contributions will equal \$25 million per annum for Years 1 and 2, \$50 million per annum for Years 3 and 4, and 10% of gross sales per annum thereafter.

(iii) Based on this analysis, FS determines that the arm's length royalty rate that USP would have charged an uncontrolled licensee for a license of future applications of Z if USP had further developed future applications of Z on its own is 30% of the sales price of the Z-based product, as determined under the comparable uncontrolled transaction method in § 1.482-4(c). In light of the expected sales growth and anticipation that the CSA Activity will not cease as of any determinable date, FS's determination includes a terminal value calculation. FS further determines that under the cost sharing alternative, the present value of FS's divisional profits, reduced by the present values of the anticipated operating cost contributions and cost contributions, would be \$1,361 million. Under the licensing alternative, the present

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value of the operating divisional profits and losses, reduced by the operating cost contributions, would be \$2,113 million, and the present value of the licensing payments would be \$1,585 million. Therefore, the total value of the licensing alternative would be \$528 million. In order for the present value of the cost sharing alternative to equal the present value of the licensing alternative, the present value of the PCT Payments must equal \$833 million. Accordingly, FS pays

USP a lump sum PCT Payment of \$833 million in Year 1 for USP's platform contributions of Z and Q.

(iv) The Commissioner undertakes an audit of the PCTs and concludes, based on his own analysis, that this lump sum PCT Payment is within the interquartile range of arm's length results for these platform contributions. The calculations made by FS in determining the PCT Payment in this *Example 7* are set forth in the following tables:

COST SHARING ALTERNATIVE

Time Period (Y = Year, TV = Terminal Value).	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	TV
Discount Period	0	1	2	3	4	5	6	7	7
Items of Income/Expense at Beginning of Year:									
1 Sales	100	100	200	400	600	650	700	750	(3% annual growth in each year from previous year).
2 Routine Cost and Operating Cost Contributions (60% of sales amount in row 1 of relevant year).	60	60	120	240	360	390	420	450	(60% of annual sales in row 1 for each year).
3 Cost Contributions (10% of sales amount in row 1 for relevant year after Year 5).	25	25	50	50	60	65	70	75	(10% of annual sales in row 1 for each year).
4 Profit = amount in row 1 reduced by amounts in rows 2 and 3.	15	15	30	110	180	195	210	225	(row 1 minus rows 2 and 3 for each year).
5 PV (using 14% discount rate).	15	13.2	23.1	74.2	107	101	95.7	89.9	842.
6 TOTAL PV of Cost Sharing Alternative = Sum of all PV amounts in Row 5 for all Time Periods = \$1,361 million.									

LICENSING ALTERNATIVE

Time Period (Y = Year, TV = Terminal Value).	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	TV
Discount Period	0	1	2	3	4	5	6	7	7
Items of Income/Expense at Beginning of Year:									
7 Sales	100	100	200	400	600	650	700	750	(3% annual growth in each year from previous year).
8 Routine Cost and Operating Cost Contributions (60% of sales amount in row 7 of relevant year).	60	60	120	240	360	390	420	450	(60% of annual sales in row 7 for each year).
9 Operating Profit = amount in Row 7 reduced by amount in Row 8.	40	40	80	160	240	260	280	300	(Row 7 minus row 8 for each year).
10 PV of row 9 (using 13% discount rate).	40	35.4	62.7	111	147	141	135	128	1313.
11 TOTAL PV FOR ALL AMOUNTS IN ROW 10 = \$2,112.7 million									
12 Licensing Payments (30% of sales amount in row 7).	30	30	60	120	180	195	210	225	(30% of amount in row 7 for each year).
13 PV of amount in row 12 (using 13% discount rate).	30	26.5	47	83.2	110	106	101	95.6	985.
14 TOTAL PV FOR ALL AMOUNTS IN ROW 13 = \$1,584.5 million.									
15 TOTAL PV of Licensing Alternative = Row 11 minus Row 14 = \$528 million.									

CALCULATION OF PCT PAYMENT

16	TOTAL PV OF COST SHARING ALTERNATIVE (FROM ROW 6 ABOVE) = ...	\$1,361 million.
17	TOTAL PV OF LICENSING ALTERNATIVE (FROM ROW 15 ABOVE) =	\$528 million.
18	LUMP SUM PCT PAYMENT = ROW 16 – ROW 17 =	\$833 million.

Example 8. (i) The facts are the same as in *Example 1*, except that the taxpayer determines that the appropriate discount rate for the cost sharing alternative is 20%. In addition, the taxpayer determines that the appropriate discount rate for the licensing alternative is 10%. Accordingly, the taxpayer determines that the appropriate present value of the PCT Payment is \$146 million.

(ii) Based on the best method analysis described in *Example 2*, the Commissioner determines that the taxpayer's calculation of the present value of the PCT Payments is outside of the interquartile range (as shown in the sixth column of *Example 2*), and thus warrants an adjustment. Furthermore, in evaluating the taxpayer's analysis, the Commissioner undertakes an analysis based on the difference in the financial projections between the cost sharing and licensing alternatives (as shown in column 11 of *Example 1*). This column shows the anticipated differential income stream of additional positive or negative income for FS over the duration of the CSA Activity that would result from undertaking the cost sharing alternative (before any PCT Payments) rather than the licensing alternative. This anticipated differential income stream thus reflects the anticipated incremental undiscounted profits to FS from the incremental activity of undertaking the risk of developing the cost shared intangibles and enjoying the value of its divisional interests. Taxpayer's analysis logically implies that the present value of this stream must be \$146 million, since only then would FS have the same anticipated value in both the cost sharing and licensing alternatives. A present value of \$146 million implies that the discount rate applicable to this stream is 34.4%. Based on a reliable calculation of discount rates applicable to the anticipated income streams of uncontrolled companies whose resources, capabilities, and rights consist primarily of software applications intangibles and research and development teams similar to USP's platform contributions to the CSA, and which income streams, accordingly, may be reasonably anticipated to reflect a similar risk profile to the differential income stream, the Commissioner concludes that an appropriate discount rate for the anticipated income stream associated with USP's platform contributions (that is, the additional positive or negative income over the duration of the CSA Activity that would result, before PCT Payments, from switching from the licensing alternative to the cost sharing alternative) is

16%, which is significantly less than 34.4%. This conclusion further suggests that Taxpayer's analysis is unreliable. See paragraphs (g)(2)(v)(B)(2) and (g)(4)(vi)(F)(1) and (2) of this section.

(iii) The Commissioner makes an adjustment of \$296 million, so that the present value of the PCT Payments is \$442 million (the median results as shown in column 6 of *Example 2*).

Example 9. The facts are the same as in *Example 1*, except that additional data on discount rates are available that were not available in *Example 1*. The Commissioner determines the arm's length charge for the PCT Payment by discounting at an appropriate rate the differential income stream associated with the rights contributed by USP in the PCT (that is, the stream of income in column (11) of *Example 1*). Based on an analysis of a set of public companies whose resources, capabilities, and rights consist primarily of resources, capabilities, and rights similar to those contributed by USP in the PCT, the Commissioner determines that 15% to 17% is an appropriate range of discount rates to use to assess the value of the differential income stream associated with the rights contributed by USP in the PCT. The Commissioner determines that applying a discount rate of 17% to the differential income stream associated with the rights contributed by USP in the PCT yields a present value of \$446 million, while applying a discount rate of 15% to the differential income stream associated with the rights contributed by USP in the PCT yields a present value of \$510 million. Because the taxpayer's result, \$446 million, is within the interquartile range determined by the Commissioner, no adjustments are warranted. See paragraphs (g)(2)(v)(B)(2), (g)(4)(v), and (g)(4)(vi)(F)(1) of this section.

(5) *Acquisition price method*—(i) *In general.* The acquisition price method applies the comparable uncontrolled transaction method of § 1.482-4(c), or the comparable uncontrolled services price method described in § 1.482-9(c), to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the amount charged (the acquisition price) for the stock or asset purchase of an entire organization or portion thereof (the target) in an uncontrolled transaction.

The acquisition price method is ordinarily used where substantially all the target's nonroutine contributions, as such term is defined in paragraph (j)(1)(i) of this section, made to the PCT Payee's business activities are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* Under this method, the arm's length charge for a PCT or group of PCTs covering resources, capabilities, and rights of the target is equal to the adjusted acquisition price, as divided among the controlled participants according to their respective RAB shares.

(iii) *Adjusted acquisition price.* The adjusted acquisition price is the acquisition price of the target increased by the value of the target's liabilities on the date of the acquisition, other than liabilities not assumed in the case of an asset purchase, and decreased by the value of the target's tangible property on that date and by the value on that date of any other resources, capabilities, and rights not covered by a PCT or group of PCTs.

(iv) *Best method analysis considerations.* The comparability and reliability considerations stated in § 1.482-4(c)(2) apply. Consistent with those considerations, the reliability of applying the acquisition price method as a measure of the arm's length charge for the PCT Payment normally is reduced if—

(A) A substantial portion of the target's nonroutine contributions to the PCT Payee's business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued;

(B) A substantial portion of the target's assets consists of tangible property that cannot reliably be valued; or

(C) The date on which the target is acquired and the date of the PCT are not contemporaneous.

(v) *Example.* The following example illustrates the principles of this paragraph (g)(5):

Example. USP, a U.S. corporation, and its newly incorporated, wholly-owned foreign subsidiary (FS) enter into a CSA at the start of Year 1 to develop Group Z products. Under the CSA, USP and FS will have the exclusive rights to exploit the Group Z products in the U.S. and the rest of the world, respectively. At the start of Year 2, USP acquires Com-

pany X for cash consideration worth \$110 million. At this time USP's RAB share is 60%, and FS's RAB share is 40% and is not reasonably anticipated to change as a result of this acquisition. Company X joins in the filing of a U.S. consolidated income tax return with USP. Under paragraph (j)(2)(i) of this section, Company X and USP are treated as one taxpayer for purposes of this section. Accordingly, the rights in any of Company X's resources and capabilities that are reasonably anticipated to contribute to the development activities of the CSA will be considered platform contributions furnished by USP. Company X's resources and capabilities consist of its workforce, certain technology intangibles, \$15 million of tangible property and other assets and \$5 million in liabilities. The technology intangibles, as well as Company X's workforce, are reasonably anticipated to contribute to the development of the Group Z products under the CSA and, therefore, the rights in the technology intangibles and the workforce are platform contributions for which FS must make a PCT Payment to USP. None of Company X's existing intangible assets or any of its workforce are anticipated to contribute to activities outside the CSA. For purposes of this example, it is assumed that no additional adjustment on account of tax liabilities is needed. Applying the acquisition price method, the value of USP's platform contributions is the adjusted acquisition price of \$100 million (\$110 million acquisition price plus \$5 million liabilities less \$15 million tangible property and other assets). FS must make a PCT Payment to USP for these platform contributions with a reasonably anticipated present value of \$40 million, which is the product of \$100 million (the value of the platform contributions) and 40% (FS's RAB share).

(6) *Market capitalization method—(i) In general.* The market capitalization method applies the comparable uncontrolled transaction method of § 1.482-4(c), or the comparable uncontrolled services price method described in § 1.482-9(c), to evaluate whether the amount charged in a PCT, or group of PCTs, is arm's length by reference to the average market capitalization of a controlled participant (PCT Payee) whose stock is regularly traded on an established securities market. The market capitalization method is ordinarily used where substantially all of the PCT Payee's nonroutine contributions to the PCT Payee's business are covered by a PCT or group of PCTs.

(ii) *Determination of arm's length charge.* Under the market capitalization method, the arm's length charge

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for a PCT or group of PCTs covering resources, capabilities, and rights of the PCT Payee is equal to the adjusted average market capitalization, as divided among the controlled participants according to their respective RAB shares.

(iii) *Average market capitalization.* The average market capitalization is the average of the daily market capitalizations of the PCT Payee over a period of time beginning 60 days before the date of the PCT and ending on the date of the PCT. The daily market capitalization of the PCT Payee is calculated on each day its stock is actively traded as the total number of shares outstanding multiplied by the adjusted closing price of the stock on that day. The adjusted closing price is the daily closing price of the stock, after adjustments for stock-based transactions (dividends and stock splits) and other pending corporate (combination and spin-off) restructuring transactions for which reliable arm's length adjustments can be made.

(iv) *Adjusted average market capitalization.* The adjusted average market capitalization is the average market capitalization of the PCT Payee increased by the value of the PCT Payee's liabilities on the date of the PCT and decreased by the value on such date of the PCT Payee's tangible property and of any other resources, capabilities, or rights of the PCT Payee not covered by a PCT or group of PCTs.

(v) *Best method analysis considerations.* The comparability and reliability considerations stated in § 1.482-4(c)(2) apply. Consistent with those considerations, the reliability of applying the comparable uncontrolled transaction method using the adjusted market capitalization of a company as a measure of the arm's length charge for the PCT Payment normally is reduced if—

(A) A substantial portion of the PCT Payee's nonroutine contributions to its business activities is not required to be covered by a PCT or group of PCTs, and that portion of the nonroutine contributions cannot reliably be valued;

(B) A substantial portion of the PCT Payee's assets consists of tangible property that cannot reliably be valued; or

(C) Facts and circumstances demonstrate the likelihood of a material

divergence between the average market capitalization of the PCT Payee and the value of its resources, capabilities, and rights for which reliable adjustments cannot be made.

(vi) *Examples.* The following examples illustrate the principles of this paragraph (g)(6):

Example 1. (i) USP, a publicly traded U.S. company, and its newly incorporated wholly-owned foreign subsidiary (FS) enter into a CSA on Date 1 to develop software. At that time USP has in-process software but has no software ready for the market. Under the CSA, USP and FS will have the exclusive rights to exploit the software developed under the CSA in the United States and the rest of the world, respectively. On Date 1, USP's RAB share is 70% and FS's RAB share is 30%. USP's assembled team of researchers and its in-process software are reasonably anticipated to contribute to the development of the software under the CSA. Therefore, the rights in the research team and in-process software are platform contributions for which compensation is due from FS. Further, these rights are not reasonably anticipated to contribute to any business activity other than the CSA Activity.

(ii) On Date 1, USP had an average market capitalization of \$205 million, tangible property and other assets that can be reliably valued worth \$5 million, and no liabilities. Aside from those assets, USP had no assets other than its research team and in-process software. Applying the market capitalization method, the value of USP's platform contributions is \$200 million (\$205 million average market capitalization of USP less \$5 million of tangible property and other assets). The arm's length value of the PCT Payments FS must make to USP for the platform contributions, before any adjustment on account of tax liability as described in paragraph (g)(2)(ii) of this section, is \$60 million, which is the product of \$200 million (the value of the platform contributions) and 30% (FS's RAB share on Date 1).

Example 2. Aggregation with make-or-sell rights. (i) The facts are the same as in *Example 1*, except that on Date 1 USP also has existing software ready for the market. USP separately enters into a license agreement with FS for make-or-sell rights for all existing software outside the United States. No marketing has occurred, and USP has no marketing intangibles. This license of current make-or-sell rights is a transaction governed by § 1.482-4. However, after analysis, it is determined that the arm's length PCT Payments and the arm's length payments for the make-or-sell license may be most reliably determined in the aggregate using the market capitalization method, under principles described in paragraph (g)(2)(iv) of this

section, and it is further determined that those principles are most reliably implemented by computing the aggregate arm's length charge as the product of the aggregate value of the existing and in-process software and FS's RAB share on Date 1.

(ii) Applying the market capitalization method, the aggregate value of USP's platform contributions and the make-or-sell rights in its existing software is \$250 million (\$255 million average market capitalization of USP less \$5 million of tangible property and other assets). The total arm's length value of the PCT Payments and licensing payments FS must make to USP for the platform contributions and current make-or-sell rights, before any adjustment on account of tax liability, if any, is \$75 million, which is the product of \$250 million (the value of the platform contributions and the make-or-sell rights) and 30% (FS's RAB share on Date 1).

Example 3. Reduced reliability. The facts are the same as in *Example 1* except that USP also has significant nonroutine assets that will be used solely in a nascent business division that is unrelated to the subject of the CSA and that cannot themselves be reliably valued. Those nonroutine contributions are not platform contributions and accordingly are not required to be covered by a PCT. The reliability of using the market capitalization method to determine the value of USP's platform contributions to the CSA is significantly reduced in this case because that method would require adjusting USP's average market capitalization to account for the significant nonroutine contributions that are not required to be covered by a PCT.

(7) *Residual profit split method*—(i) *In general.* The residual profit split method evaluates whether the allocation of combined operating profit or loss attributable to one or more platform contributions subject to a PCT is arm's length by reference to the relative value of each controlled participant'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 (relevant business activity) of the controlled participants for which data are available that include the CSA Activity. The residual profit split method may not be used where only one controlled participant makes significant nonroutine contributions (including platform or operating contributions) to the CSA Activity. The provisions of § 1.482-6 shall apply to CSAs only to the extent provided and as modified in this paragraph (g)(7).

Any other application to a CSA of a residual profit method not described in paragraphs (g)(7)(ii) and (iii) of this section will constitute an unspecified method for purposes of sections 482 and 6662(e) and the regulations under those sections.

(ii) *Appropriate share of profits and losses.* The relative value of each controlled participant'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 best method analysis described in § 1.482-1(c) and (d). 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 participants engaged in the relevant business activity. The profit allocated to any particular controlled participant is not necessarily limited to the total operating profit of the group from the relevant business activity. For example, in a given year, one controlled participant may earn a profit while another controlled participant 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.

(iii) *Profit split*—(A) *In general.* Under the residual profit split method, the present value of each controlled participant's residual divisional profit or loss attributable to nonroutine contributions (nonroutine residual divisional profit or loss) is allocated between the controlled participants that each furnish significant nonroutine contributions (including platform or operating contributions) to the relevant business activity in that division.

(B) *Determine nonroutine residual divisional profit or loss.* The present value of each controlled participant's nonroutine residual divisional profit or loss must be determined to reflect the most reliable measure of an arm's length result. The present value of nonroutine residual divisional profit or loss equals

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the present value of the stream of the reasonably anticipated residuals over the duration of the CSA Activity of divisional profit or loss, minus market returns for routine contributions, minus operating cost contributions, minus cost contributions, using a discount rate appropriate to such residuals in accordance with paragraph (g)(2)(v) of this section. As used in this paragraph (g)(7), the phrase “market returns for routine contributions” includes market returns for operating cost contributions and excludes market returns for cost contributions.

(C) *Allocate nonroutine residual divisional profit or loss—(1) In general.* The present value of nonroutine residual divisional profit or loss in each controlled participant's division must be allocated among all of the controlled participants based upon the relative values, determined as of the date of the PCTs, of the PCT Payor's as compared to the PCT Payee's nonroutine contributions to the PCT Payor's division. For this purpose, the PCT Payor's nonroutine contribution consists of the sum of the PCT Payor's nonroutine operating contributions and the PCT Payor's RAB share of the PCT Payor's nonroutine platform contributions. For this purpose, the PCT Payee's nonroutine contribution consists of the PCT Payor's RAB share of the PCT Payee's nonroutine platform contributions.

(2) *Relative value determination.* The relative values of the controlled participants' nonroutine contributions must be determined so as to reflect the most reliable measure of an arm's length result. Relative values may be measured by external market benchmarks that reflect the fair market value of such nonroutine contributions. Alternatively, the relative value of nonroutine contributions may be estimated by the capitalized cost of developing the nonroutine contributions and updates, as appropriately grown or discounted so that all contributions may be valued on a comparable dollar basis as of the same date. If the nonroutine contributions by a controlled participant are also used in other business activities (such as the exploitation of make-or-sell rights described in paragraph (c)(4) of this section), an allocation of the value of the nonroutine con-

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tributions must be made on a reasonable basis among all the business activities in which they are used in proportion to the relative economic value that the relevant business activity and such other business activities are anticipated to derive over time as the result of such nonroutine contributions.

(3) *Determination of PCT Payments.* Any amount of the present value of a controlled participant's nonroutine residual divisional profit or loss that is allocated to another controlled participant represents the present value of the PCT Payments due to that other controlled participant for its platform contributions to the relevant business activity in the relevant division. For purposes of paragraph (j)(3)(ii) of this section, the present value of a PCT Payor's PCT Payments under this paragraph shall be deemed reduced to the extent of the present value of any PCT Payments owed to it from other controlled participants under this paragraph (g)(7). The resulting remainder may be converted to a fixed or contingent form of payment in accordance with paragraph (h) (Form of payment rules) of this section.

(4) *Routine platform and operating contributions.* For purposes of this paragraph (g)(7), any routine platform or operating contributions, the valuation and PCT Payments for which are determined and made independently of the residual profit split method, are treated similarly to cost contributions and operating cost contributions, respectively. Accordingly, wherever used in this paragraph (g)(7), the term “routine contributions” shall not include routine platform or operating contributions, and wherever the terms “cost contributions” and “operating cost contributions” appear in this paragraph (g)(7), they shall include net routine platform contributions and net routine operating contributions, respectively, as defined in paragraph (g)(4)(vii) of this section. However, treatment of net operating contributions as operating cost contributions shall be coordinated with the treatment of other routine contributions pursuant to paragraphs (g)(4)(iii)(B) and (7)(iii)(B) of this section so as to avoid duplicative market returns to such contributions.

(iv) *Best method analysis 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 quality of data, reliability of assumptions, and sensitivity of results to possible deficiencies in the 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 in the context of the relevant business activity of developing and exploiting cost shared intangibles is discussed in paragraphs (g)(7)(iv)(B) through (D) of this section.

(B) *Comparability*. The derivation of the present value of nonroutine residual divisional profit or loss includes a carveout on account of market returns for routine contributions. Thus, the comparability considerations that are relevant for that purpose include those that are relevant for the methods that are used to determine market returns for the routine contributions.

(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 between the relevant business activity and the controlled participants' other activities that will affect the reliability of the determination of the divisional profit or loss and its allocation among the controlled participants. See § 1.482-6(c)(2)(ii)(C)(1).

(2) The degree of consistency between the controlled participants and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit or loss affects the reliability of the result. See § 1.482-6(c)(2)(ii)(C)(2).

(3) The reliability of the data used and the assumptions made in estimating the relative value of the nonroutine contributions by the controlled participants. In particular, if capital-

ized costs of development are used to estimate the relative value of nonroutine contributions, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate. This is because, in any given case, the costs of developing a nonroutine contribution may not be related to its market value and because the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled participant's other activities, which may affect the reliability of the analysis.

(D) *Other factors affecting reliability*. Like the methods described in §§ 1.482-3 through 1.482-5 and § 1.482-9(c), the carveout on account of market returns for routine contributions relies exclusively on external market benchmarks. As indicated in § 1.482-1(c)(2)(i), as the degree of comparability between the controlled participants and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of nonroutine residual divisional profit or loss 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 the controlled participants are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all the controlled participants is affected by the reliability of the data and the assumptions pertaining to each controlled participant. Thus, if the data and assumptions are significantly more reliable with respect to one of the controlled participants than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(v) *Examples*. The following examples illustrate the principles of this paragraph (g)(7):

Example 1. (i) For simplicity of calculation in this *Example 1*, all financial flows are assumed to occur at the beginning of each period. USP, a U.S. electronic data storage

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company, has partially developed technology for a type of extremely small compact storage devices (nanodisks) which are expected to provide a significant increase in data storage capacity in various types of portable devices such as cell phones, MP3 players, laptop computers and digital cameras. At the same time, USP's wholly-owned subsidiary, FS, has developed significant marketing intangibles outside the United States in the form of customer lists, ongoing relations with various OEMs, and trademarks that are well recognized by consumers due to a long history of marketing successful data storage devices and other hardware used in various types of consumer electronics. At the beginning of Year 1, USP enters into a CSA with FS to develop nanodisk technologies for eventual commercial exploitation. Under the CSA, USP will have the right to exploit nanodisks in the United States, while FS will have the right to exploit nanodisks in the rest of the world. The partially developed nanodisk technologies owned by USP are reasonably anticipated to contribute to the development of commercially exploitable nanodisks and therefore the rights in the nanodisk technologies constitute platform contributions of USP for which compensation is due under PCTs. FS does not have any platform contributions for the CSA. Due to the fact that nanodisk technologies have yet to be incorporated into any commercially available product, neither USP nor FS transfers rights to make or sell current products in conjunction with the CSA.

(ii) Because only in FS's territory do both controlled participants make significant nonroutine contributions, USP and FS determine that they need to determine the relative value of their respective contributions to residual divisional profit or loss attributable to the CSA Activity only in FS's territory. FS anticipates making no nanodisk sales during the first year of the CSA in its territory with revenues in Year 2 reaching \$200 million. Revenues through Year 5 are reasonably anticipated to increase by 50% per year. The annual growth rate for revenues is then expected to decline to 30% per annum in Years 6 and 7, 20% per annum in Years 8 and 9 and 10% per annum in Year 10.

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Revenues are then expected to decline 10% in Year 11 and 5% per annum, thereafter. The routine costs (defined here as costs other than cost contributions, routine platform and operating contributions, and nonroutine contributions) that are allocable to this revenue in calculating FS's divisional profit or loss, are anticipated to equal \$40 million for the first year of the CSA and \$130 for the second year and \$200 and \$250 million in Years 3 and 4. Total operating expenses attributable to product exploitation (including operating cost contributions) equal 52% of sales per year. FS undertakes routine distribution activities in its markets that constitute routine contributions to the relevant business activity of exploiting nanodisk technologies. USP and FS estimate that the total market return on these routine contributions will amount to 6% of the routine costs. FS expects its cost contributions to be \$60 million in Year 1, rise to \$100 million in Years 2 and 3, and then decline again to \$60 million in Year 4. Thereafter, FS's cost contributions are expected to equal 10% of revenues.

(iii) USP and FS determine the present value of the stream of the reasonably anticipated residuals in FS's territory over the duration of the CSA Activity of the divisional profit or loss (revenues minus routine costs), minus the market returns for routine contributions, the operating cost contributions, and the cost contributions. USP and FS determine, based on the considerations discussed in paragraph (g)(2)(v) of this section, that the appropriate discount rate is 17.5% per annum. Therefore, the present value of the nonroutine residual divisional profit is \$1,395 million.

(iv) After analysis, USP and FS determine that the relative value of the nanodisk technologies contributed by USP to CSA (giving effect only to its value in FS's territory) is roughly 150% of the value of FS's marketing intangibles (which only have value in FS's territory). Consequently, 60% of the nonroutine residual divisional profit is attributable to USP's platform contribution. Therefore, FS's PCT Payments should have an expected present value equal to \$837 million (.6 × \$1,395 million).

(v) The calculations for this *Example 1* are displayed in the following table:

Time Period (Y = Year) (TV = Terminal Value)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	Y11	TV
Discount Period	0	1	2	3	4	5	6	7	8	9	10	10
[1] Sales	0	200	300	450	675	878	1141	1369	1643	1807	1940	1626
[2] Growth Rate	50%	50%	50%	50%	30%	30%	20%	20%	10%	10%	10%	-10%
[3] Exploitation Costs and Operating Cost Contributions (52% of Sales [1])	40	130	200	250	351	456	593	712	854	940	946	846
[4] Return on [3] (6% of [3])	2.4	8	12	15	21	27	36	43	51	56	51	51
[5] Cost Contributions (10% of Sales [1] after Year 5)	60	100	100	60	68	88	114	137	164	181	163	163
[6] Residual Profit = [1] minus {[3] + [4] + [5]}	-102	-38	-12	125	235	306	398	477	573	630	567	2395
[7] Residual Profit [6] Discounted at 17.5% discount rate ...	-102	-32	-9	77	124	137	151	154	158	148	113	477
[8] Sum of all amounts in [7] for all time periods = \$1,395 million												
[9] Relative value in FS's division of USP's nanotechnology to FS's marketing intangibles = 150%												
[10] Profit Split (USP)												60% = 1.5 × [11]
[11] Profit Split (FS)												40%
[12] FS's PCT Payments												[8] × [10] = \$1,395 million × 60% = \$837 million

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Example 2. (i) For simplicity of calculation in this *Example 2*, all financial flows are assumed to occur at the beginning of each period. USP is a U.S. automobile manufacturing company that has completed significant research on the development of diesel-electric hybrid engines that, if they could be successfully manufactured, would result in providing a significant increased fuel economy for a wide variety of motor vehicles. Successful commercialization of the diesel-electric hybrid engine will require the development of a new class of advanced battery that will be light, relatively cheap to manufacture and yet capable of holding a substantial electric charge. FS, a foreign subsidiary of USP, has completed significant research on developing lithium-ion batteries that appear likely to have the requisite characteristics. At the beginning of Year 1, USP enters into a CSA with FS to further develop diesel-electric hybrid engines and lithium-ion battery technologies for eventual commercial exploitation. Under the CSA, USP will have the right to exploit the diesel-electric hybrid engine and lithium-ion battery technologies in the United States, while FS will have the right to exploit such technologies in the rest of the world. The partially developed diesel-electric hybrid engine and lithium-ion battery technologies owned by USP and FS, respectively, are reasonably anticipated to contribute to the development of commercially exploitable automobile engines and therefore the rights in both these technologies constitute platform contributions of USP and of FS for which compensation is due under PCTs. At the time of inception of the CSA, USP owns operating intangibles in the form of self-developed marketing intangibles which have significant value in the United States, but not in the rest of the world, and that are relevant to exploiting the cost shared intangibles. Similarly, FS owns self-developed marketing intangibles which have significant value in the rest of the world, but not in the United States, and that are relevant to exploiting the cost shared intangibles. Although the new class of diesel-electric hybrid engine using lithium-ion batteries is not yet ready for commercial exploitation, components based on this technology are beginning to be incorporated in current-generation gasoline-electric hybrid engines and the rights to make and sell such products are transferred from USP to FS and vice-versa in conjunction with the inception of the CSA, following the same territorial division as in the CSA.

(ii) USP's estimated RAB share is 66.7%. During Year 1, it is anticipated that sales in USP's territory will be \$1000X in Year 1. Sales in FS's territory are anticipated to be \$500X. Thereafter, as revenue from the use of components in gasoline-electric hybrids is supplemented by revenues from the production of complete diesel-electric hybrid en-

gines using lithium-ion battery technology, anticipated sales in both territories will increase rapidly at a rate of 50% per annum through Year 4. Anticipated sales are then anticipated to increase at a rate of 40% per annum for another 4 years. Sales are then anticipated to increase at a rate of 30% per annum through Year 10. Thereafter, sales are anticipated to decrease at a rate of 5% per annum for the foreseeable future as new automotive drivetrain technologies displace diesel-electric hybrid engines and lithium-ion batteries. Total operating expenses attributable to product exploitation (including operating cost contributions) equal 40% of sales per year for both USP and FS. USP and FS estimate that the total market return on these routine contributions to the CSA will amount to 6% of these operating expenses. USP is expected to bear $\frac{2}{3}$ of the total cost contributions for the foreseeable future. Cost contributions are expected to total \$375X in Year 1 (of which \$250X are borne by USP) and increase at a rate of 25% per annum through Year 6. In Years 7 through 10, cost contributions are expected to increase 10% a year. Thereafter, cost contributions are expected to decrease by 5% a year for the foreseeable future.

(iii) USP and FS determine the present value of the stream of FS's reasonably anticipated residual divisional profit, which is the stream of FS's reasonably anticipated divisional profit or loss, minus the market returns for routine contributions, minus operating cost contributions, minus cost contributions. USP and FS determine, based on the considerations discussed in paragraph (g)(2)(v) of this section, that the appropriate discount rate is 12% per year. Therefore, the present value of the nonroutine residual divisional profit in USP's territory is \$41,727X and in CFC's territory is \$20,864X.

(iv) After analysis, USP and FS determine that, in the United States the relative value of the technologies contributed by USP and FS to the CSA and of the operating intangibles used by USP in the exploitation of the cost shared intangibles (reported as equaling 100 in total), equals: USP's platform contribution (59.5); FS's platform contribution (25.5); and USP's operating intangibles (15). Consequently, the present value of the arm's length amount of the PCT Payments that USP should pay to FS for FS's platform contribution is \$10,640X ($.255 \times \$41,727X$). Similarly, USP and FS determine that, in the rest of the world, the relative value of the technologies contributed by USP and FS to the CSA and of the operating intangibles used by FS in the exploitation of the cost shared intangibles can be divided as follows: USP's platform contribution (63); FS's platform contribution (27); and FS's operating intangibles (10). Consequently, the present value of the arm's length amount of the PCT Payments that FS should pay to USP for

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USP's platform contribution is $\$13,144X (.63 \times \$20,864X)$. Therefore, FS is required to make a net payment to USP with a present value of $\$2,504X (\$13,144X - 10,640X)$.

(v) The calculations for this *Example 2* are displayed in the following tables:

CALCULATION OF USP's PCT PAYMENT TO FS

Time Period (Y = Year) (TV = Terminal Value)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	TV
0	1	2	3	4	5	6	7	8	9	9	9
[1] Sales	1000	1500	2250	3375	4725	6615	9261	12965	16855	21912	
[2] Growth Rate	50%	50%	50%	50%	40%	40%	40%	40%	30%	30%	
[3] Exploitation Costs and Operating Cost Contributions (40% of Sales [1])	400	600	900	1350	1890	2646	3704	5186	6742	8765	
[4] Return on [3] = 6% of [3]	24	36	54	81	113	159	222	311	405	526	
[5] Cost Contributions ..	250	313	391	488	610	763	839	923	1015	1117	
[6] Residual Profit = [1] minus {[3] + [4] + [5]}	326	552	905	1456	2111	3047	4495	6545	8693	11504	64287
[7] Residual Profit [6] Discounted at 12% discount rate	326	492	722	1036	1342	1729	2277	2961	3511	4148	23183

[8] Sum of all amounts in [7] for all time periods = $\$41,727X$

Profit Split for Calculation of USP's PCT Payment to FS: [Total of US contributions = 74.5%]

[9] USP's Platform Contribution = 59.5%

[10] FS's Platform Contribution = 25.5%

[11] USP's Operating Intangibles = 15%

[12] USP's PCT Payment to FS = [8] \times [10] = $\$41,727X$ multiplied by 25.5% = $\$10,640X$

CALCULATION OF FS's NET PCT PAYMENT TO USF

Time Period (Y = Year) (TV = Terminal Value)	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8	Y9	Y10	TV
0	1	2	3	4	5	6	7	8	9	9	9
[13] Sales	500	750	1125	1688	2363	3308	4631	6483	8428	10956	
[14] Growth Rate	50%	50%	50%	50%	40%	40%	40%	40%	30%	30%	
[15] Exploitation Costs and Operating Cost Contributions (40% of Sales [13])	200	300	450	675	945	1323	1852	2593	3371	4382	
[16] Return on [15] = 6% of [15]	12	18	27	41	57	79	111	156	202	263	
[17] Cost Contributions	125	156	195	244	305	381	420	462	508	559	
[18] Residual Profit = [13] minus {[15] + [16] + [17]}	163	276	453	728	1056	1524	2248	3272	4347	5752	32144
[19] Residual Profit [18] Discounted at 12% dis- count rate	163	246	361	518	671	865	1139	1480	1755	2074	11591

[20] Sum of all amounts in [19] for all time periods = $\$20,864X$

Profit Split for Calculation of FS's PCT Payment to USF: [Total of FS's contributions = 37%]

[21] USP's Platform Contribution = 63%

[22] FS's Platform Contribution = 27%

[23] FS's Operating Intangibles = 10%

CALCULATION OF FS'S NET PCT PAYMENT TO USF—Continued

[24] FS's PCT Payment to USP = [20] × [21] = \$20,864X multiplied by 63% = \$13,144X

[25] FS's Net PCT Payment to USP = [24] minus [12] = \$13,144X minus \$10,640X = \$2,504X

(8) *Unspecified methods.* Methods not specified in paragraphs (g)(3) through (7) of this section may be used to evaluate whether the amount charged for a PCT is arm's length. Any method used under this paragraph (g)(8) must be applied in accordance with the provisions of § 1.482-1 and of paragraph (g)(2) of this section. 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. Therefore, in establishing whether a PCT achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled participant could have realized by choosing a realistic alternative to the CSA. See paragraph (k)(2)(ii)(J) of this section. 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) (Best method rule). In accordance with § 1.482-1(d) (Comparability), to the extent that an unspecified 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.

(h) *Form of payment rules—(1) CST Payments.* CST Payments may not be paid in shares of stock in the payor (or stock in any member of the controlled group that includes the controlled participants).

(2) *PCT Payments—(i) In general.* The consideration under a PCT for a platform contribution may take one or a combination of both of the following forms:

(A) Payments of a fixed amount (fixed payments), either paid in a lump sum payment or in installment payments spread over a specified period, with interest calculated in accordance with § 1.482-2(a) (Loans or advances).

(B) Payments contingent on the exploitation of cost shared intangibles by the PCT Payor (contingent payments). Accordingly, controlled participants have flexibility to adopt a form and period of payment, provided that such form and period of payment are consistent with an arm's length charge as of the date of the PCT. See also paragraphs (h)(2)(iv) and (3) of this section.

(ii) *No PCT Payor Stock.* PCT Payments may not be paid in shares of stock in the PCT Payor (or stock in any member of the controlled group that includes the controlled participants).

(iii) *Specified form of payment—(A) In general.* The form of payment selected (subject to the rules of this paragraph (h)) for any PCT, including, in the case of contingent payments, the contingent base and structure of the payments as set forth in paragraph (h)(2)(iii)(B) of this section, must be specified no later than the due date of the applicable tax return (including extensions) for the later of the taxable year of the PCT Payor or PCT Payee that includes the date of that PCT.

(B) *Contingent payments.* In accordance with paragraph (k)(1)(iv)(A) of this section, a provision of a written contract described in paragraph (k)(1) of this section, or of the additional documentation described in paragraph (k)(2) of this section, that provides for payments for a PCT (or group of PCTs) to be contingent on the exploitation of cost shared intangibles will be respected as consistent with economic substance only if the allocation between the controlled participants of the risks attendant on such form of payment is determinable before the outcomes of such allocation that would

have materially affected the PCT pricing are known or reasonably knowable. A contingent payment provision must clearly and unambiguously specify the basis on which the contingent payment obligations are to be determined. In particular, the contingent payment provision must clearly and unambiguously specify the events that give rise to an obligation to make PCT Payments, the royalty base (such as sales or revenues), and the computation used to determine the PCT Payments. The royalty base specified must be one that permits verification of its proper use by reference to books and records maintained by the controlled participants in the normal course of business (for example, books and records maintained for financial accounting or business management purposes).

(C) *Examples.* The following examples illustrate the principles of this paragraph (h)(2).

Example 1. A CSA provides that PCT Payments with respect to a particular platform contribution shall be contingent payments equal to 15% of the revenues from sales of products that incorporate cost shared intangibles. The terms further permit (but do not require) the controlled participants to adjust such contingent payments in accordance with a formula set forth in the arrangement so that the 15% rate is subject to adjustment by the controlled participants at their discretion on an after-the-fact, uncompensated basis. The Commissioner may impute payment terms that are consistent with economic substance with respect to the platform contribution because the contingent payment provision does not specify the computation used to determine the PCT Payments.

Example 2. Taxpayer, an automobile manufacturer, is a controlled participant in a CSA that involves research and development to perfect certain manufacturing techniques necessary to the actual manufacture of a state-of-the-art, hybrid fuel injection system known as DRL337. The arrangement involves the platform contribution of a design patent covering DRL337. Pursuant to paragraph (h)(2)(iii)(B) of this section, the CSA provides for PCT Payments with respect to the platform contribution of the patent in the form of royalties contingent on sales of automobiles that contain the DRL337 system. However, Taxpayer's system of book- and record-keeping does not enable Taxpayer to track which automobile sales involve automobiles that contain the DRL337 system. Because Taxpayer has not complied with paragraph (h)(2)(iii)(B) of this section, the Com-

missioner may impute payment terms that are consistent with economic substance and susceptible to verification by the Commissioner.

Example 3. (i) Controlled participants A and B enter into a CSA that provides for PCT Payments from A to B with respect to B's platform contribution, Z, in the form of three annual installment payments due from A to B on the last day of each of the first three years of the CSA.

(ii) On audit, based on all the facts and circumstances, the Commissioner determines that the installment PCT Payments are consistent with an arm's length charge as of the date of the PCT. Accordingly, the Commissioner does not make an adjustment with respect to the PCT Payments in any year.

Example 4. (i) The facts are the same as in *Example 3* except that the CSA contains an additional term with respect to the PCT Payments. Under this provision, A and B further agreed that, if the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is less than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period, then the third installment payment shall be subject to a compensating adjustment in the amount necessary to reduce the present value (as of the CSA Start Date) of the aggregate PCT Payments for those three years to the amount that would have been calculated if the actual results had been used for the calculation instead of the projected results.

(ii) This provision further specifies that A will pay B an additional amount, \$Q, in the first year of the CSA to compensate B for taking on additional downside risk through the contingent payment term described in paragraph (i) of this *Example 4*.

(iii) During the first two years, A pays B installment payments as agreed, as well as the additional amount, \$Q. In the third year, A and B determine that the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is less than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period. A reduces the PCT Payment to B in the third year in the amount necessary to reduce the present value (as of the CSA Start Date) of the aggregate PCT Payments for those three years to the amount that would have been calculated if the actual results had been used for the calculation instead of the projected results.

(iv) On audit, based on all the facts and circumstances, the Commissioner determines that the installment PCT Payments agreed to be paid by A to B were consistent with an arm's length charge as of the date of the

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PCT. The Commissioner further determines that the contingency was sufficiently specified such that its occurrence or nonoccurrence was unambiguous and determinable; that the projections were reliable; and that the contingency did, in fact, occur. Finally, the Commissioner determines, based on all the facts and circumstances, that \$Q was within the arm's length range for the additional allocation of risk to B. Accordingly, no adjustment is made with respect to the installment PCT Payments, or the additional PCT Payment for the contingent payment term, in any year.

Example 5. (i) The facts are the same as in *Example 4* except that the CSA states the amount that A will pay B for the contingent payment term is \$X, an amount that is less than \$Q, and A pays B \$X in the first year of the CSA.

(ii) On audit, based on all the facts and circumstances, the Commissioner determines that the installment PCT Payments agreed to be paid by A to B were consistent with an arm's length charge as of the date of the PCT. The Commissioner further determines that the contingency was sufficiently specified such that its occurrence or nonoccurrence was unambiguous and determinable; that the projections were reliable; and that the contingency did, in fact, occur. However, the Commissioner also determines, based on all the facts and circumstances, that the additional PCT Payment of \$X from A to B for the contingent payment term was not an arm's length charge for the additional allocation of risk as of the CSA Start Date in connection with the contingent payment term. Accordingly, the Commissioner makes an adjustment to B's results equal to the difference between \$X and the median of the arm's length range of charges for the contingent payment term.

Example 6. (i) The facts are the same as in *Example 3* except that A and B further agreed that, if the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is either less or greater than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period, then A may make a compensating adjustment to the third installment payment in the amount necessary to reduce (if actual divisional operating profit or loss is less than the projections) or increase (if actual divisional operating profit or loss exceeds the projections) the present value (as of the CSA Start Date) of the aggregate PCT Payments for those three years to the amount that would have been calculated if the actual results had been used for the calculation instead of the projected results.

(ii) On audit, the Commissioner determines that the contingent payment term lacks eco-

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nomic substance under §§1.482-1(d)(3)(iii)(B) and 1.482-7(h)(2)(iii)(B). It lacks economic substance because the allocation of the risks between A and B was indeterminate as of the CSA Start Date due to the elective nature of the potential compensating adjustments. Specifically, the parties agreed upfront only that A might make compensating adjustments to the installment payments. By the terms of the agreement, A could decide whether to make such adjustments after the outcome of the risks was known or reasonably knowable. Even though the contingency and potential compensating adjustments were clearly defined in the CSA, no compensating adjustments were required by the CSA regardless of the occurrence or nonoccurrence of the contingency. As a result, the contingent payment terms did not clearly and unambiguously specify the events that give rise to an obligation to make PCT Payments, and, accordingly, the obligation to make compensating adjustments pursuant to the contingency was indeterminate. The contingent payment term allows the taxpayer to make adjustments that are favorable to its overall tax position in those years where the agreement allows it to make such adjustments, but decline to exercise its right to make any adjustment in those years in which such an adjustment would be unfavorable to its overall tax position. Such terms do not reflect a substantive upfront allocation of risk. In addition, the vagueness of the agreement makes it impossible to determine whether such contingent payment term warrants an additional arm's length charge and, if so, how much.

(iii) Accordingly, the Commissioner may disregard the contingent payment term under §§1.482-1(d)(3)(ii)(B)(I) and 1.482-7(k)(1)(iv) and may impute other contractual terms in its place consistent with the economic substance of the CSA.

Example 7. (i) The facts are the same as in *Example 6* except that the contingent payment term provides that, if the present value (as of the CSA Start Date) of A's actual divisional operating profit or loss during the three-year period is either less or greater than the present value (as of the CSA Start Date) of the divisional operating profit or loss that the parties projected for A upon formation of the CSA for that period, then A will make a compensating adjustment to the third installment payment. The CSA does not specify the amount of (or a formula for) any such compensating adjustments.

(ii) On audit, the Commissioner determines that the contingent payment term lacks economic substance under §§1.482-1(d)(3)(iii)(B) and 1.482-7(h)(2)(iii)(B). It lacks economic substance because the allocation of the risks between A and B was indeterminate as of the CSA Start Date due to the failure to specify the amount of (or a formula for) the compensating adjustments that must be made if a

contingency occurs. The basis on which the compensating adjustments were to be determined was neither clear nor unambiguous. Even though the contingency was clearly defined in the CSA and the requirement of a compensating adjustment in the event of a contingency was clearly specified in the CSA, the parties had no agreement regarding the amount of such compensating adjustments. As a result, the computation used to determine the PCT Payments was indeterminate. The parties could choose to make a small positive compensating adjustment if the actual results turned out to be much greater than the projections, and could choose to make a significant negative compensating adjustment if the actual results turned out to be less than the projections. Such terms do not reflect a substantive up-front allocation of risk. In addition, the vagueness of the agreement makes it impossible to determine whether such contingent payment term warrants an additional arm's length charge and, if so, how much.

(ii) Accordingly, the Commissioner may disregard the contingent price term under §§1.482-1(d)(3)(ii)(B)(I) and 1.482-7(k)(1)(iv) and may impute other contractual terms in its place consistent with economic substance of the CSA.

(iv) *Conversion from fixed to contingent form of payment.* With regard to a conversion of a fixed present value to a contingent form of payment, see paragraphs (g)(2)(v) (Discount rate) and (vi) (Financial projections) of this section.

(3) *Coordination of best method rule and form of payment.* A method described in paragraph (g)(1) of this section evaluates the arm's length amount charged in a PCT in terms of a form of payment (method payment form). For example, the method payment form for the acquisition price method described in paragraph (g)(5) of this section, and for the market capitalization method described in paragraph (g)(6) of this section, is fixed payment. Applications of the income method provide different method payment forms. See paragraphs (g)(4)(i)(E) and (iv) of this section. The method payment form may not necessarily correspond to the form of payment specified pursuant to paragraphs (h)(2)(iii) and (k)(2)(ii)(l) of this section (specified payment form). The determination under §1.482-1(c) of the method that provides the most reliable measure of an arm's length result is to be made without regard to whether the respective method payment forms under the

competing methods correspond to the specified payment form. If the method payment form of the method determined under §1.482-1(c) to provide the most reliable measure of an arm's length result differs from the specified payment form, then the conversion from such method payment form to such specified payment form will be made to the satisfaction of the Commissioner.

(i) *Allocations by the Commissioner in connection with a CSA—(1) In general.* The Commissioner may make allocations to adjust the results of a controlled transaction in connection with a CSA so that the results are consistent with an arm's length result, in accordance with the provisions of this paragraph (i).

(2) *CST allocations—(i) In general.* The Commissioner may make allocations to adjust the results of a CST so that the results are consistent with an arm's length result, including any allocations to make each controlled participant's IDC share, as determined under paragraph (d)(4) of this section, equal to that participant's RAB share, as determined under paragraph (e)(1) of this section. Such allocations may result from, for purposes of CST determinations, adjustments to—

(A) Redetermine IDCs by adding any costs (or cost categories) that are directly identified with, or are reasonably allocable to, the IDA, or by removing any costs (or cost categories) that are not IDCs;

(B) Reallocate costs between the IDA and other business activities;

(C) Improve the reliability of the selection or application of the basis used for measuring benefits for purposes of estimating a controlled participant's RAB share;

(D) Improve the reliability of the projections used to estimate RAB shares, including adjustments described in paragraph (i)(2)(ii) of this section; and

(E) Allocate among the controlled participants any unallocated interests in cost shared intangibles.

(ii) *Adjustments to improve the reliability of projections used to estimate RAB shares—(A) Unreliable projections.* A significant divergence between projected benefit shares and benefit shares

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adjusted to take into account any available actual benefits to date (adjusted benefit shares) may indicate that the projections were not reliable for purposes of estimating RAB shares. In such a case, the Commissioner may use adjusted benefit shares as the most reliable measure of RAB shares and adjust IDC shares accordingly. The projected benefit shares will not be considered unreliable, as applied in a given taxable year, based on a divergence from adjusted benefit shares for every controlled participant that is less than or equal to 20% of the participant's projected benefits share. Further, the Commissioner will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the controlled participants, which could not reasonably have been anticipated at the time that costs were shared. The Commissioner generally may adjust projections of benefits used to calculate benefit shares in accordance with the provisions of § 1.482-1. In particular, 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. For purposes of this paragraph (i)(2)(ii)(A), all controlled participants that are not U.S. persons are treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection of RAB shares will be made to the IDC shares of foreign controlled participants only if there is a matching adjustment to the IDC shares of controlled participants that are U.S. persons. Nothing in this paragraph (i)(2)(ii)(A) prevents the Commissioner from making an allocation if a taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures its anticipated benefits based on units sold, and the Commissioner 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.

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(B) *Foreign-to-foreign adjustments.* Adjustments to IDC shares based on an unreliable projection also may be made among foreign controlled participants if the variation between actual and projected benefits has the effect of substantially reducing U.S. tax.

(C) *Correlative adjustments to PCTs.* Correlative adjustments will be made to any PCT Payments of a fixed amount that were determined based on RAB shares that are subsequently adjusted on a finding that they were based on unreliable projections. No correlative adjustments will be made to contingent PCT Payments regardless of whether RAB shares were used as a parameter in the valuation of those payments.

(D) *Examples.* The following examples illustrate the principles of this paragraph (i)(2)(ii):

Example 1. U.S. Parent (USP) and Foreign Subsidiary (FS) enter into a CSA 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 Commissioner examines the controlled participants' method for dividing costs. USP and FS actually accounted for 42% and 58% of total sales, respectively. The Commissioner 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 adjusted and projected benefit shares are less than 20% of their projected benefit shares, the projection of future benefits for Year 3 is reliable.

Example 2. The facts are the same as in *Example 1*, except that in Year 3 USP and FS actually accounted for 35% and 65% of total sales, respectively. The divergence between USP's projected and adjusted 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 controlled participants. The Commissioner concludes that the projected benefit shares were unreliable, and uses adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 3. U.S. Parent (USP), a U.S. corporation, and its foreign subsidiary (FS) enter into a CSA in Year 1. They project that they will begin to receive benefits from cost shared 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 controlled participants'

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projections, the Commissioner compares the adjusted benefit shares to the projected benefit shares. Although USP's adjusted benefit share (50%) is within 20% of its projected benefit share (60%), FS's adjusted benefit share (50%) is not within 20% of its projected benefit share (40%). Based on this discrepancy, the Commissioner may conclude that the controlled participants' projections were unreliable and may use adjusted benefit shares as the basis for an adjustment to the cost shares borne by USP and FS.

Example 4. Three controlled taxpayers, USP, FS1, and FS2 enter into a CSA. FS1 and FS2 are foreign. USP is a domestic corporation that controls all the stock of FS1 and FS2. The controlled participants project that they will share the total benefits of the cost shared intangibles in the following percentages: USP 50%; FS1 30%; and FS2 20%. Adjusted benefit shares are as follows: USP 45%; FS1 25%; and FS2 30%. In evaluating the reliability of the controlled participants' projections, the Commissioner compares these adjusted benefit shares to the projected benefit shares. For this purpose, FS1 and FS2 are treated as a single controlled participant. The adjusted benefit share received by USP (45%) is within 20% of its projected benefit share (50%). In addition, the non-US controlled participant's adjusted benefit share (55%) is also within 20% of their projected benefit share (50%). Therefore, the Commissioner concludes that the controlled participant's projections of future benefits were reliable, despite the fact that FS2's adjusted benefit share (30%) is not within 20% of its projected benefit share (20%).

Example 5. The facts are the same as in *Example 4*. In addition, the Commissioner 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 Commissioner concludes that the controlled 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 paragraph (i)(2)(ii)(B) of this section, the Commissioner 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 adjusted and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

Example 6. (i)(A) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a CSA 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 CSA 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
1	5	10
2	20	20
3	30	30
4	40	40
5	40	40
6	40	40
7	40	40
8	20	20
9	10	10
10	5	5

(B) In Year 1, 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 Year 1, 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 Year 6, the Commissioner examines the CSA. USS and FP have obtained the following sales results through Year 5:

SALES
[In millions of dollars]

Year	USS	FP
1	0	17
2	17	35
3	25	35
4	38	41
5	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 Year 5 both parties' sales had leveled off at approximately their projected values. Taking into account this leveling off of sales and

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all the facts and circumstances, the Commissioner determines that it is appropriate to use the original projections for the remaining years of sales. Combining the actual results through Year 5 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 adjusted benefit shares are within 20% of the benefit shares calculated based on the original sales projections, the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were not unreliable. No adjustment is made based on the difference between adjusted and projected benefit shares.

Example 7. (i) The facts are the same as in *Example 6*, except that the actual sales results through Year 5 are as follows:

SALES [In millions of dollars]		
Year	USS	FP
1	0	17
2	17	35
3	25	44
4	34	54
5	36	55

(ii) Based on the discrepancy between the projections and the actual results and on consideration of all the facts, the Commissioner 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
6	36	55
7	36	55
8	18	28
9	9	14
10	4.5	7

(iii) Combining the actual results through Year 5 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 adjusted benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the Commissioner determines that, based on the difference between adjusted and projected benefit shares, the original projections were un-

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reliable. The Commissioner adjusts cost shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

(iii) *Timing of CST allocations.* If the Commissioner makes an allocation to adjust the results of a CST, the allocation must be reflected for tax purposes in the year in which the IDCs were incurred. When a CST payment is owed by one controlled participant to another controlled participant, the Commissioner 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).

(3) *PCT allocations.* The Commissioner may make allocations to adjust the results of a PCT so that the results are consistent with an arm's length result in accordance with the provisions of the applicable sections of the regulations under section 482, as determined pursuant to paragraph (a)(2) of this section.

(4) *Allocations regarding changes in participation under a CSA.* The Commissioner may make allocations to adjust the results of any controlled transaction described in paragraph (f) of this section if the controlled participants do not reflect arm's length results in relation to any such transaction.

(5) *Allocations when CSTs are consistently and materially disproportionate to RAB shares.* If a controlled participant bears IDC shares that are consistently and materially greater or lesser than its RAB share, then the Commissioner may conclude that the economic substance of the arrangement between the controlled participants is inconsistent with the terms of the CSA. In such a case, the Commissioner may disregard such terms and impute an agreement that is consistent with the controlled participants' course of conduct, under which a controlled participant that bore a disproportionately greater IDC share received additional interests in the cost shared intangibles. See §§ 1.482-1(d)(3)(ii)(B) (Identifying contractual terms) and 1.482-4(f)(3)(ii) (Identification of owner). Such additional interests will consist of partial undivided interests in the other controlled participant's interest in the cost shared intangible. Accordingly,

that controlled participant must receive arm's length consideration from any controlled participant whose IDC share is less than its RAB share over time, under the provisions of §§ 1.482-1 and 1.482-4 through 1.482-6 to provide compensation for the latter controlled participants' use of such partial undivided interest.

(6) *Periodic adjustments*—(i) *In general*. Subject to the exceptions in paragraph (i)(6)(vi) of this section, the Commissioner may make periodic adjustments for an open taxable year (the Adjustment Year) and for all subsequent taxable years for the duration of the CSA Activity with respect to all PCT Payments, if the Commissioner determines that, for a particular PCT (the Trigger PCT), a particular controlled participant that owes or owed a PCT Payment relating to that PCT (such controlled participant being referred to as the PCT Payor for purposes of this paragraph (i)(6)) has realized an Actually Experienced Return Ratio (AERR) that is outside the Periodic Return Ratio Range (PRRR). The satisfaction of the condition stated in the preceding sentence is referred to as a Periodic Trigger. See paragraphs (i)(6)(ii) through (vi) of this section regarding the PRRR, the AERR, and periodic adjustments. In determining whether to make such adjustments, the Commissioner may consider whether the outcome as adjusted more reliably reflects an arm's length result under all the relevant facts and circumstances, including any information known as of the Determination Date. The Determination Date is the date of the relevant determination by the Commissioner. The failure of the Commissioner to determine for an earlier taxable year that a PCT Payment was not arm's length will not preclude the Commissioner from making a periodic adjustment for a subsequent year. A periodic adjustment under this paragraph (i)(6) may be made without regard to whether the taxable year of the Trigger PCT or any other PCT remains open for statute of limitations purposes or whether a periodic adjustment has previously been made with respect to any PCT Payment.

(ii) *PRRR*. Except as provided in the next sentence, the PRRR will consist of

return ratios that are not less than .667 nor more than 1.5. Alternatively, if the controlled participants have not substantially complied with the documentation requirements referenced in paragraph (k) of this section, as modified, if applicable, by paragraphs (m)(2) and (3) of this section, the PRRR will consist of return ratios that are not less than .8 nor more than 1.25.

(iii) *AERR*—(A) *In general*. The AERR is the present value of total profits (PVTP) divided by the present value of investment (PVI). In computing PVTP and PVI, present values are computed using the applicable discount rate (ADR), and all information available as of the Determination Date is taken into account.

(B) *PVTP*. The PVTP is the present value, as of the CSA Start Date, as defined in section (j)(1)(i) of this section, of the PCT Payor's actually experienced divisional profits or losses from the CSA Start Date through the end of the Adjustment Year.

(C) *PVI*. The PVI is the present value, as of the CSA Start Date, of the PCT Payor's investment associated with the CSA Activity, defined as the sum of its cost contributions and its PCT Payments, from the CSA Start Date through the end of the Adjustment Year. For purposes of computing the PVI, PCT Payments means all PCT Payments due from a PCT Payor before netting against PCT Payments due from other controlled participants pursuant to paragraph (j)(3)(ii) of this section.

(iv) *ADR*—(A) *In general*. Except as provided in paragraph (i)(6)(iv)(B) of this section, the ADR is the discount rate pursuant to paragraph (g)(2)(v) of this section, subject to such adjustments as the Commissioner determines appropriate.

(B) *Publicly traded companies*. If the PCT Payor meets the conditions of paragraph (i)(6)(iv)(C) of this section, the ADR is the PCT Payor WACC as of the date of the Trigger PCT. However, if the Commissioner determines, or the controlled participants establish to the satisfaction of the Commissioner, that a discount rate other than the PCT Payor WACC better reflects the degree of risk of the CSA Activity as of such

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date, the ADR is such other discount rate.

(C) *Publicly traded.* A PCT Payor meets the conditions of this paragraph (i)(6)(iv)(C) if—

(1) Stock of the PCT Payor is publicly traded; or

(2) Stock of the PCT Payor is not publicly traded, provided the PCT Payor is included in a group of companies for which consolidated financial statements are prepared; and a publicly traded company in such group owns, directly or indirectly, stock in PCT Payor. Stock of a company is publicly traded within the meaning of this paragraph (i)(6)(iv)(C) if such stock is regularly traded on an established United States securities market and the company issues financial statements prepared in accordance with United States generally accepted accounting principles for the taxable year.

(D) *PCT Payor WACC.* The *PCT Payor WACC* is the WACC, as defined in paragraph (j)(1)(i) of this section, of the PCT Payor or the publicly traded company described in paragraph (i)(6)(iv)(C)(2)(ii) of this section, as the case may be.

(E) *Generally accepted accounting principles.* For purposes of paragraph (i)(6)(iv)(C) of this section, 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 the amounts of debt, equity, and interest expense are reflected in any 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.

(v) *Determination of periodic adjustments.* In the event of a Periodic Trigger, subject to paragraph (i)(6)(vi) of this section, the Commissioner may make periodic adjustments with respect to all PCT Payments between all PCT Payors and PCT Payees for the Adjustment Year and all subsequent

years for the duration of the CSA Activity pursuant to the residual profit split method as provided in paragraph (g)(7) of this section, subject to the further modifications in this paragraph (i)(6)(v). A periodic adjustment may be made for a particular taxable year without regard to whether the taxable years of the Trigger PCT or other PCTs remain open for statute of limitation purposes.

(A) *In general.* Periodic adjustments are determined by the following steps:

(1) First, determine the present value, as of the date of the Trigger PCT, of the PCT Payments under paragraph (g)(7)(iii)(C)(3) of this section pursuant to the Adjusted RPSM as defined in paragraph (i)(6)(v)(B) of this section (first step result).

(2) Second, convert the first step result into a stream of contingent payments on a base of reasonably anticipated divisional profits or losses over the entire duration of the CSA Activity, using a level royalty rate (second step rate). See paragraph (h)(2)(iv) of this section (Conversion from fixed to contingent form of payment). This conversion is made based on all information known as of the Determination Date.

(3) Third, apply the second step rate to the actual divisional profit or loss for taxable years preceding and including the Adjustment Year to yield a stream of contingent payments for such years, and convert such stream to a present value as of the CSA Start Date under the principles of paragraph (g)(2)(v) of this section (third step result). For this purpose, the second step rate applied to a loss for a particular year will yield a negative contingent payment for that year.

(4) Fourth, convert any actual PCT Payments up through the Adjustment Year to a present value as of the CSA Start Date under the principles of paragraph (g)(2)(v) of this section. Then subtract such amount from the third step result. Determine the nominal amount in the Adjustment Year that would have a present value as of the CSA Start Date equal to the present value determined in the previous sentence to determine the periodic adjustment in the Adjustment Year.

(5) Fifth, apply the second step rate to the actual divisional profit or loss for each taxable year after the Adjustment Year up to and including the taxable year that includes the Determination Date to yield a stream of contingent payments for such years. For this purpose, the second step rate applied to a loss will yield a negative contingent payment for that year. Then subtract from each such payment any actual PCT Payment made for the same year to determine the periodic adjustment for such taxable year.

(6) For each taxable year subsequent to the year that includes the Determination Date, the periodic adjustment for such taxable year (which is in lieu of any PCT Payment that would otherwise be payable for that year under the taxpayer's position) equals the second step rate applied to the actual divisional profit or loss for that year. For this purpose, the second step rate applied to a loss for a particular year will yield a negative contingent payment for that year.

(7) If the periodic adjustment for any taxable year is a positive amount, then it is an additional PCT Payment owed from the PCT Payor to the PCT Payee for such year. If the periodic adjustment for any taxable year is a negative amount, then it is an additional PCT Payment owed by the PCT Payee to the PCT Payor for such year.

(B) *Adjusted RPSM as of Determination Date.* The Adjusted RPSM is the residual profit split method pursuant to paragraph (g)(7) of this section applied to determine the present value, as of the date of the Trigger PCT, of the PCT Payments under paragraph (g)(7)(iii)(C)(3) of this section, with the following modifications.

(1) Actual results up through the Determination Date shall be substituted for what otherwise were the projected results over such period, as reasonably anticipated as of the date of the Trigger PCT.

(2) Projected results for the balance of the CSA Activity after the Determination Date, as reasonably anticipated as of the Determination Date, shall be substituted for what otherwise were the projected results over such period, as reasonably anticipated as of the date of the Trigger PCT.

(3) The requirement in paragraph (g)(7)(i) of this section, that at least two controlled participants make significant nonroutine contributions, does not apply.

(vi) *Exceptions to periodic adjustments—(A) Controlled participants establish periodic adjustment not warranted.* No periodic adjustment will be made under paragraphs (i)(6)(i) and (v) of this section if the controlled participants establish to the satisfaction of the Commissioner that all the conditions described in one of paragraphs (i)(6)(vi)(A)(1) through (4) of this section apply with respect to the Trigger PCT.

(1) *Transactions involving the same platform contribution as in the Trigger PCT.*

(i) The same platform contribution is furnished to an uncontrolled taxpayer under substantially the same circumstances as those of the relevant Trigger PCT and with a similar form of payment as the Trigger PCT;

(ii) This transaction serves as the basis for the application of the comparable uncontrolled transaction method described in paragraph (g)(3) of this section, in the first year and all subsequent years in which substantial PCT Payments relating to the Trigger PCT were required to be paid; and

(iii) The amount of those PCT Payments in that first year was arm's length.

(2) *Results not reasonably anticipated.* The differential between the AERR and the nearest bound of the PRRR is due to extraordinary events beyond the control of the controlled participants that could not reasonably have been anticipated as of the date of the Trigger PCT.

(3) *Reduced AERR does not cause Periodic Trigger.* The Periodic Trigger would not have occurred had the PCT Payor's divisional profits or losses used to calculate its PVTP both taken into account expenses on account of operating cost contributions and routine platform contributions, and excluded those profits or losses attributable to the PCT Payor's routine contributions to its exploitation of cost shared intangibles, nonroutine contributions to the

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CSA Activity, operating cost contributions, and routine platform contributions.

(4) *Increased AERR does not cause Periodic Trigger*—(i) The Periodic Trigger would not have occurred had the divisional profits or losses of the PCT Payor used to calculate its PVTP included its reasonably anticipated divisional profits or losses after the Adjustment Year from the CSA Activity, including from its routine contributions, its operating cost contributions, and its nonroutine contributions to that activity, and had the cost contributions and PCT Payments of the PCT Payor used to calculate its PVI included its reasonably anticipated cost contributions and PCT Payments after the Adjustment Year. The reasonably anticipated amounts in the previous sentence are determined based on all information available as of the Determination Date.

(ii) For purposes of this paragraph (i)(6)(vi)(A)(4), the controlled participants may, if they wish, assume that the average yearly divisional profits or losses for all taxable years prior to and including the Adjustment Year, in which there has been substantial exploitation of cost shared intangibles resulting from the CSA (exploitation years), will continue to be earned in each year over a period of years equal to 15 minus the number of exploitation years prior to and including the Determination Date.

(B) *Circumstances in which Periodic Trigger deemed not to occur*. No Periodic Trigger will be deemed to have occurred at the times and in the circumstances described in paragraph (i)(6)(vi)(B)(1) or (2) of this section.

(1) *10-year period*. In any year subsequent to the 10-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, if the AERR determined is within

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the PRRR for each year of such 10-year period.

(2) *5-year period*. In any year of the 5-year period beginning with the first taxable year in which there is substantial exploitation of cost shared intangibles resulting from the CSA, if the AERR falls below the lower bound of the PRRR.

(vii) *Examples*. The following examples illustrate the rules of this paragraph (i)(6):

Example 1. (i) For simplicity of calculation in this *Example 1*, all financial flows are assumed to occur at the beginning of the year. At the beginning of Year 1, USP, a publicly traded U.S. company, and FS, its wholly-owned foreign subsidiary, enter into a CSA to develop new technology for cell phones. USP has a platform contribution, the rights for an in-process technology that when developed will improve the clarity of calls, for which compensation is due from FS. FS has no platform contributions to the CSA, no operating contributions, and no operating cost contributions. USP and FS agree to fixed PCT payments of \$40 million in Year 1 and \$10 million per year for Years 2 through 10. At the beginning of Year 1, the weighted average cost of capital of the controlled group that includes USP and FS is 15%. In Year 9, the Commissioner audits Years 5 through 7 of the CSA and considers whether any periodic adjustments should be made. USP and FS have substantially complied with the documentation requirements of paragraph (k) of this section.

(ii) FS experiences the results reported in the following table from its participation in the CSA through Year 7. In the table, all present values (PV) are reported as of the CSA Start Date, which is the same as the date of the PCT (and reflect a 15% discount rate as discussed in paragraph (iii) of this *Example 1*). Thus, in any year the present value of the cumulative investment is PVI and of the cumulative divisional profit or loss is PVTP. All amounts in this table and the tables that follow are reported in millions of dollars and cost contributions are referred to as “CCs” (for simplicity of calculation in this *Example 1*, all financial flows are assumed to occur at the beginning of the year).

a Year	b Sales	c Non CC costs	d CCs	e PCT pay- ments	f Investment (d + e)	g Divisional profit or loss (b-c)	h AERR (PVTP/ PVI) (g/f)
1	0	0	15	40	55	0	
2	0	0	17	10	27	0	
3	0	0	18	10	28	0	
4	705	662	20	10	30	46	
5	886	718	22	10	32	168	

a	b	c	d	e	f	g	h
Year	Sales	Non CC costs	CCs	PCT payments	Investment (d + e)	Divisional profit or loss (b-c)	AERR (PVTP/PVI) (g/f)
6	1,113	680	24	10	34	433	
7	1,179	747	27	10	37	432	
PV through Year 5	970	846	69	69	138	124	0.90
PV through Year 6	1,523	1,184	81	74	155	340	2.20
PV through Year 7	2,033	1,507	93	78	171	526	3.09

(iii) Because USP is publicly traded in the United States and is a member of the controlled group to which FS (the PCT Payor) belongs, for purposes of calculating the AERR for FS, the present values of its PVTP and PVI are determined using an ADR of 15%, the weighted average cost of capital of the controlled group. (It is assumed that no other rate was determined or established, under paragraph (i)(6)(iv)(B) of this section, to better reflect the relevant degree of risk.) At a 15% discount rate, the PVTP, calculated as of Year 1, and based on actual profits realized by FS through Year 7 from exploiting the new cell phone technology developed by the CSA, is \$526 million. The PVI, based on FS's cost contributions and its PCT Payments, is \$171 million. The AERR for FS is equal to its PVTP divided by its PVI, \$526 million/\$171 million, or 3.09. There is a Periodic Trigger because FS's AERR of 3.09 falls outside the PRRR of .67 to 1.5, the applicable PRRR for controlled participants complying with the documentation requirements of this section.

(iv) At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger oc-

curred was Year 6, when the AERR of FS was determined to be 2.20. It is also determined that for Year 6 none of the exceptions to periodic adjustments described in paragraph (i)(6)(vi) of this section applies. The Commissioner exercises its discretion under paragraph (i)(6)(i) of this section to make periodic adjustments using Year 6 as the Adjustment Year. Therefore, the arm's length PCT Payments from FS to USP shall be determined for each taxable year using the adjusted residual profit split method described in paragraphs (g)(7) and (i)(6)(v)(B) of this section. Periodic adjustments will be made for each year to the extent the PCT Payments actually made by FS differ from the PCT Payment calculation under the adjusted residual profit split method.

(v) It is determined, as of the Determination Date, that the cost shared intangibles will be exploited through Year 10. FS's return for routine contributions (determined by the Commissioner, based on the return for comparable functions undertaken by comparable uncontrolled companies, to be 8% of non-CC costs), and its actual and projected results, are described in the following table.

a	b	c	d	e	f	g
Year	Sales	Non-CC costs	Divisional profit or loss (b-c)	CCs	Routing return	Residual profit (d-e-f)
1	0	0	0	15	0	-15
2	0	0	0	17	0	-17
3	0	0	0	18	0	-18
4	705	662	43	20	53	-30
5	886	718	168	22	57	89
6	1,113	680	433	24	54	355
7	1,179	747	432	27	60	345
8	1,238	822	416	29	66	321
9	1,300	894	406	32	72	302
10	1,365	974	391	35	78	278
Cumulative PV through Year 10 as of CSA Start Date	3,312	2,385	927	124	191	612

(vi) The periodic adjustments are calculated in a series of steps set out in paragraph (i)(6)(v)(A) of this section. First, a lump sum for the PCT Payment is determined using the adjusted residual profit split method. Under the method, based on the con-

siderations discussed in paragraph (g)(2)(v) of this section, the appropriate discount rate is 15% per year. The nonroutine residual divisional profit or loss described in paragraph (g)(7)(iii)(B) of this section is \$612 million. Further, under paragraph (g)(7)(iii)(C) of this

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section, the entire nonroutine residual divisional profit constitutes the PCT Payment because only USP has nonroutine contributions.

(vii) In step two, the first step result (\$612 million) is converted into a level royalty rate based on the reasonably anticipated divisional profit or losses of the CSA Activity, the PV of which is reported in the table above (net PV of divisional profit or loss for Years 1 through 10 is \$927 million). Consequently, the step two result is a level royalty rate of 66.0% ($\$612/\927) of the divisional profit in Years 1 through 10.

(viii) In step three, the Commissioner calculates the PCT Payments due through Year 6 by applying the step two royalty rate to the actual divisional profits for each year

and then determines the aggregate PV of these PCT Payments as of the CSA Start Date (\$224 million as reported in the following table). In step four, the PCT Payments actually made through Year 6 are similarly converted to PV as of the CSA Start Date (\$74 million) and subtracted from the amount determined in step three (\$224 million—\$74 million = \$150 million). That difference of \$150 million, representing a net PV as of the CSA Start Date, is then converted to a nominal amount, as of the Adjustment Year, of equivalent present value (again using a discount rate of 15%). That nominal amount is \$302 million (not shown in the table), and is the periodic adjustment in Year 6.

a	b	c	d	e
Year	Divisional profit	Royalty rate	Nominal royalty due under adjusted RPSM (b*c)	Nominal payments made
Year 1	0	66.0	\$0	\$40
Year 2	0	66.0	0	10
Year 3	0	66.0	0	10
Year 4	43	66.0	28	10
Year 5	168	66.0	111	10
Year 6	433	66.0	286	10
Cumulative PV as of Year 1			224	74

(ix) Under step five, the royalties due from FS to USP for Year 7 (the year after the Adjustment Year) through Year 9 (the year including the Determination Date) are determined. (These determinations are made for Years 8 and 9 after the divisional profit for those years becomes available.) For each year, the periodic adjustment is a PCT Payment due in addition to the \$10 million PCT

Payment that must otherwise be paid under the CSA as described in paragraph (i) of this *Example 1*. That periodic adjustment is calculated as the product of the step two royalty rate and the divisional profit, minus the \$10 million that was otherwise paid for that year. The calculations are shown in the following table:

a	b	c	d	e	f
Year	Divisional profit	Royalty rate	Royalty due (b*c)	PCT Payments otherwise paid	Periodic adjustment d-e)
7	432	66.0%	\$285	\$10	\$275
8	416	66.0	275	10	265
9	406	66.0	268	10	258

(x) Under step six, the periodic adjustment for Year 10 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to the divisional profit. This periodic adjustment is a PCT Payment pay-

able from FS to USP, and is in lieu of the \$10 payment otherwise due. The calculations are shown in the following table, based on a divisional profit of \$391 million. USP and FS experienced the following results in Year 10.

Year	Divisional profit	Royalty rate	Royalty due	PCT payment called for under original agreement but not made	Periodic adjustment
10	391	66.0%	\$258	\$10 (not paid)	\$258

Example 2. The facts are the same as in paragraphs (i) through (iii) of *Example 1*. At the time of the Determination Date, it is determined that the first Adjustment Year in which a Periodic Trigger occurred was Year 6, when the AERR of FS was determined to be 2.73. Upon further investigation as to what may have caused the high return in FS's market, the Commissioner learns that, in Years 4 through 6, USP's leading competitors experienced severe, unforeseen disruptions in their supply chains resulting in a significant increase in USP's and FS's market share for cell phones. Further analysis determines that without this unforeseen occurrence the Periodic Trigger would not have occurred. Based on paragraph (i)(6)(vi)(A)(2) of this section, the Commissioner determines to his satisfaction that no adjustments are warranted.

Example 3. (i) USP, a U.S. corporation, and its wholly-owned foreign subsidiaries FS1, FS2, and FS3 enter into a CSA at the start of Year 1 to develop version 2.0 of a computer program. USP makes a platform contribution, version 1.0 of the program (upon which version 2.0 will be based), for which compensation is due from FS1, FS2, and FS3. None of the foreign subsidiaries makes any platform contributions.

(ii) In Year 6, the Commissioner audits Years 3 through 5 of the CSA and considers whether any periodic adjustments should be made. At the time of the Determination

Date, the Commissioner determines that the first Adjustment Year in which a Periodic Trigger occurred was Year 3, and further determines that none of the exceptions to periodic adjustments described in paragraph (i)(6)(vi) of this section applies. The Commissioner exercises his discretion under paragraph (i)(6)(i) of this section to make periodic adjustments using Year 3 as the Adjustment Year. Therefore, the arm's length PCT Payments from FS1, FS2, and FS3 to USP shall be determined using the adjusted residual profit split method described in paragraphs (g)(7)(v)(B) and (i)(6)(v)(B) of this section. Periodic adjustments will be made for each year to the extent the PCT Payments actually made by FS1, FS2, and FS3 differ from the PCT Payment calculation under the adjusted residual profit split method.

(iii) The periodic adjustments are calculated in a series of steps set out in paragraph (i)(6)(v)(A) of this section. First, a lump sum for the PCT Payments is determined using the adjusted residual profit split method. The following results are calculated (based on actual results for years for which actual results are available and projected results for all years thereafter) in order to apply the adjusted residual profit split method (it is determined that the cost shared intangibles will be exploited through Year 7, so the results reported in the following table are cumulative values through Year 7):

Participant	Divisional profits (cumulative PV through year 7 as of the CSA start date)	Residual profits (cumulative PV through year 7 as of the CSA start date)
FS1	\$667	\$314
FS2	271	159
FS3	592	295

Because only USP had nonroutine contributions, under paragraph (g)(7)(iii)(C) of this section, the entire nonroutine residual divisional profit constitutes the PCT Payment owed to USP. Therefore, the present values (as of the CSA Start Date) of the PCT Payments owed are as follows:

PCT Payment owed from FS1 to USP: \$314 million

PCT Payment owed from FS2 to USP: \$159 million

PCT Payment owed from FS3 to USP: \$295 million

Pursuant to paragraph (i)(6)(v)(A) of this section, the steps in paragraphs (i)(6)(v)(A)(2) through (7) of this section are performed separately for the PCT Payments that are owed to USP by each of FS1, FS2, and FS3.

(iv) First, the steps are performed with respect to FS1. In step two, the first step result (\$314 million) is converted into a level royalty rate based on FS1's reasonably anticipated divisional profits or losses through

Year 7 (the PV of which is \$667 million). Consequently, the step two result is a level royalty rate of 47.1% (\$314/\$667) of the divisional profits in Years 1 through 7. In step three, the Commissioner calculates the PCT Payments due through Year 3 (the Adjustment Year) by applying the step two royalty rate (47.1%) to FS1's actual divisional profits for each year up to and including Year 3 and then determining the aggregate PV of these PCT Payments as of Year 3. In step four, the PCT Payments actually made by FS1 to USP through Year 3 are similarly converted to a PV as of Year 3 and subtracted from the amount determined in step three. That difference is the periodic adjustment in Year 3 with respect to the PCT Payments made for Years 1 through 3 from FS1 to USP. Under step five, the royalties due from FS1 to USP for Year 4 (the year after the Adjustment Year) through Year 6 (the year including the Determination Date) are determined. The

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periodic adjustment for each of these years is calculated as the product of the step two royalty rate and the divisional profit for that year, minus any actual PCT Payment made by FS1 to USP in that year. The periodic adjustment for each such year is a PCT Payment due in addition to the PCT Payment from FS1 to USP that was already made under the CSA. Under step six, the periodic adjustment for Year 7 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to FS1's divisional profit for that year. This periodic adjustment for Year 7 is a PCT Payment payable from FS1 to USP and is in lieu of any PCT Payment from FS1 to USP otherwise due.

(v) Next, the steps in paragraphs (i)(6)(v)(A)(2) through (7) of this section are performed with respect to FS2. In step two, the first step result (\$159 million) is converted into a level royalty rate based on FS2's reasonably anticipated divisional profits or losses through Year 7 (the PV of which is \$271 million). Consequently, the step two result is a level royalty rate of 58.7% (\$159/\$271) of the divisional profits in Years 1 through 7. In step three, the Commissioner calculates the PCT Payments due through Year 3 (the Adjustment Year) by applying the step two royalty rate (58.7%) to FS2's actual divisional profits for each year up to and including Year 3 and then determining the aggregate PV of these PCT Payments as of Year 3. In step four, the PCT Payments actually made by FS2 to USP through Year 3 are similarly converted to a PV as of Year 3 and subtracted from the amount determined in step three. That difference is the periodic adjustment in Year 3 with respect to the PCT Payments made for Years 1 through 3 from FS2 to USP. Under step five, the royalties due from FS2 to USP for Year 4 (the year after the Adjustment Year) through Year 6 (the year including the Determination Date) are determined. The periodic adjustment for each of these years is calculated as the product of the step two royalty rate and the divisional profit for that year, minus any actual PCT Payment made by FS2 to USP in that year. The periodic adjustment for each such year is a PCT Payment due in addition to the PCT Payment from FS2 to USP that was already made under the CSA. Under step six, the periodic adjustment for Year 7 (the only exploitation year after the year con-

taining the Determination Date) will be determined by applying the step two royalty rate to FS2's divisional profit for that year. This periodic adjustment for Year 7 is a PCT Payment payable from FS2 to USP and is in lieu of any PCT Payment from FS2 to USP otherwise due.

(vi) Finally, the steps in paragraphs (i)(6)(v)(A)(2) through (7) of this section are performed with respect to FS3. In step two, the first step result (\$295 million) is converted into a level royalty rate based on FS3's reasonably anticipated divisional profits or losses through Year 7 (the PV of which is \$592 million). Consequently, the step two result is a level royalty rate of 49.8% (\$295/\$592) of the divisional profits in Years 1 through 7. In step three, the Commissioner calculates the PCT Payments due through Year 3 (the Adjustment Year) by applying the step two royalty rate (49.8%) to FS3's actual divisional profits for each year up to and including Year 3 and then determining the aggregate PV of these PCT Payments as of Year 3. In step four, the PCT Payments actually made by FS3 to USP through Year 3 are similarly converted to a PV as of Year 3 and subtracted from the amount determined in step three. That difference is the periodic adjustment in Year 3 with respect to the PCT Payments made for Years 1 through 3 from FS3 to USP. Under step five, the royalties due from FS3 to USP for Year 4 (the year after the Adjustment Year) through Year 6 (the year including the Determination Date) are determined. The periodic adjustment for each of these years is calculated as the product of the step two royalty rate and the divisional profit for that year, minus any actual PCT Payment made by FS3 to USP in that year. The periodic adjustment for each such year is a PCT Payment due in addition to the PCT Payment from FS3 to USP that was already made under the CSA. Under step six, the periodic adjustment for Year 7 (the only exploitation year after the year containing the Determination Date) will be determined by applying the step two royalty rate to FS3's divisional profit for that year. This periodic adjustment for Year 7 is a PCT Payment payable from FS3 to USP and is in lieu of any PCT Payment from FS3 to USP otherwise due.

(j) *Definitions and special rules—(1) Definitions—(i) In general.* For purposes of this section—

Term	Definition	Main cross references
Acquisition price		§ 1.482-7(g)(5)(i).
Adjusted acquisition price		§ 1.482-7(g)(5)(iii).
Adjusted average market capitalization		§ 1.482-7(g)(6)(iv).
Adjusted benefit shares		§ 1.482-7(i)(2)(ii)(A).
Adjusted RPSM		§ 1.482-7(i)(6)(v)(B).
Adjustment Year		§ 1.482-7(i)(6)(i).
ADR		§ 1.482-7(i)(6)(iv).
AERR		§ 1.482-7(i)(6)(iii).

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Term	Definition	Main cross references
Applicable Method	§ 1.482-7(g)(2)(ix)(A). § 1.482-7(g)(6)(iii). § 1.482-7(e)(1)(i).
Average market capitalization .....	.....
Benefits	<i>Benefits</i> mean the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.	
Capability variation .....	.....	§ 1.482-7(f)(3).
Change in participation under a CSA .....	.....	§ 1.482-7(f).
Consolidated group .....	.....	§ 1.482-7(j)(2)(i).
Contingent payments .....	.....	§ 1.482-7(h)(2)(i)(B).
Controlled participant	<i>Controlled participant</i> means a controlled taxpayer, as defined under § 1.482-1(i)(5), that is a party to the contractual agreement that underlies the CSA, and that reasonably anticipates that it will derive benefits, as defined in paragraph (e)(1)(i) of this section, from exploiting one or more cost shared intangibles.	§ 1.482-7(a)(1).
Controlled transfer of interests .....	.....	§ 1.482-7(f)(2).
Cost contribution .....	.....	§ 1.482-7(d)(4).
Cost shared intangible	<i>Cost shared intangible</i> means any intangible, within the meaning of § 1.482-4(b), that is developed by the IDA, including any portion of such intangible that reflects a platform contribution. Therefore, an intangible developed by the IDA is a cost shared intangible even though the intangible was not always or was never a reasonably anticipated cost shared intangible.	§ 1.482-7(b).
Cost sharing alternative .....	.....	§ 1.482-7(g)(4)(i)(B).
Cost sharing arrangement or CSA .....	.....	§ 1.482-7(a), (b).
Cost sharing transactions or CSTs .....	.....	§ 1.482-7(a)(1), (b)(1)(i).
Cross operating contributions	A cross operating contribution is any resource or capability or right, other than a platform contribution, that a controlled participant has developed, maintained, or acquired prior to the CSA Start Date, or subsequent to the CSA start date by means other than operating cost contributions or cost contributions, that is reasonably anticipated to contribute to the CSA Activity within another controlled participant's division.	§ 1.482-7(a)(3)(iii), (g)(2)(iv).
CSA Activity	<i>CSA Activity</i> is the activity of developing and exploiting cost shared intangibles.	§ 1.482-7(c)(2)(i).
CSA Start Date	The <i>CSA Start Date</i> is the earlier of the date of the CSA contract or the first occurrence of any IDC to which the CSA applies, in accordance with § 1.482-7(k)(1)(iii).	§ 1.482-7(i)(6)(iii)(B) and (k)(1)(ii) and (iii).
CST Payments .....	.....	§ 1.482-7(b)(1). § 1.482-7(b)(3).
Date of PCT .....	.....	§ 1.482-7(i)(6)(i).
Determination Date .....	.....	§ 1.482-7(g)(4)(vi)(F)(2).
Differential income stream .....	.....	See definitions of divisional profit or loss, operating contribution, and operating cost contribution.
Division	<i>Division</i> means the territory or other division that serves as the basis of the division of interests under the CSA in the cost shared intangibles pursuant to § 1.482-7(b)(4).	
Divisional interest	<i>Divisional profit or loss</i> means the operating profit or loss as separately earned by each controlled participant in its division from the CSA Activity, determined before any expense (including amortization) on account of cost contributions, operating cost contributions, routine platform and operating contributions, nonroutine contributions (including platform and operating contributions), and tax.	§ 1.482-7(b)(1)(iii), (b)(4). § 1.482-7(g)(4)(iii).
Divisional profit or loss		

Term	Definition	Main cross references
Fixed payments		§ 1.482-7(h)(2)(i)(A).
Implied discount rate		§ 1.482-7(g)(2)(v)(B)(2).
IDC share		§ 1.482-7(d)(4).
Input parameters		§ 1.482-7(g)(2)(ix)(B).
Intangible development activity or IDA		§ 1.482-7(d)(1).
Intangible development costs or IDCs		§ 1.482-7(a)(1), (d)(1).
Licensing alternative		§ 1.482-7(g)(4)(i)(C).
Licensing payments	<i>Licensing payments</i> means payments pursuant to the licensing obligations under the licensing alternative.	§ 1.482-7(g)(4)(i)(iii).
Make-or-sell rights		§ 1.482-7(c)(4), (g)(2)(iv).
Market-based input parameter		§ 1.482-7(g)(2)(ix)(B).
Market returns for routine contributions	<i>Market returns for routine contributions</i> means returns determined by reference to the returns achieved by uncontrolled taxpayers engaged in activities similar to the relevant business activity in the controlled participant's division, consistent with the methods described in §§ 1.482-3, 1.482-4, 1.482-5, or § 1.482-9(c).	§ 1.482-7(g)(4), (g)(7).
Method payment form		§ 1.482-7(h)(3).
Nonroutine contributions	<i>Nonroutine contributions</i> means a controlled participant's contributions to the relevant business activities that are not routine contributions. Nonroutine contributions ordinarily include both nonroutine platform contributions and nonroutine operating contributions used by controlled participants in the commercial exploitation of their interests in the cost shared intangibles (for example, marketing intangibles used by a controlled participant in its division to sell products that are based on the cost shared intangible).	§ 1.482-7(g).
Nonroutine residual divisional profit or loss		§ 1.482-7(g)(7)(iii).
Operating contributions	An <i>operating contribution</i> is any resource or capability or right, other than a platform contribution, that a controlled participant has developed, maintained, or acquired prior to the CSA Start Date, or subsequent to the CSA Start Date by means other than operating cost contributions or cost contributions, that is reasonably anticipated to contribute to the CSA Activity within the controlled participant's division.	§ 1.482-7(g)(2)(ii), (g)(4)(vi)(E), (g)(7)(iii)(A) and (C).
Operating cost contributions	<i>Operating cost contributions</i> means all costs in the ordinary course of business on or after the CSA Start Date that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, developing resources, capabilities, or rights (other than reasonably anticipated cost shared intangibles) that are reasonably anticipated to contribute to the CSA Activity within the controlled participant's division.	§ 1.482-7(g)(2)(ii), (g)(4)(iii), (g)(7)(iii)(B).
PCT Payee		§ 1.482-7(b)(1)(ii).
PCT Payment		§ 1.482-7(b)(1)(ii).
PCT Payor		§ 1.482-7(b)(1)(ii), (i)(6)(i).
PCT Payor WACC		§ 1.482-7(i)(6)(iv)(D).
Periodic adjustments		§ 1.482-7(i)(6)(i).
Periodic Trigger		§ 1.482-7(i)(6)(i).
Platform contribution transaction or PCT		§ 1.482-7(a)(2), (b)(1)(ii).
Platform contributions		§ 1.482-7(c)(1).
Post-tax income		§ 1.482-7(g)(2)(v)(B)(4), (g)(4)(i)(G).
Pre-tax income		§ 1.482-7(g)(2)(v)(B)(4), (g)(4)(i)(G).
Projected benefit shares		§ 1.482-7(i)(2)(ii)(A).
PRRR		§ 1.482-7(i)(6)(ii).

Term	Definition	Main cross references
PVI .....	.....	§ 1.482-7(i)(6)(iii)(C).
PVTP .....	.....	§ 1.482-7(i)(6)(iii)(B).
Reasonably anticipated benefits	A controlled participant's <i>reasonably anticipated benefits</i> mean the benefits that reasonably may be anticipated to be derived from exploiting cost shared intangibles. For purposes of this definition, benefits mean the sum of additional revenue generated, plus cost savings, minus any cost increases from exploiting cost shared intangibles.	§ 1.482-7(e)(1).
Reasonably anticipated benefits or RAB shares.	.....	§ 1.482-7(a)(1), (e)(1).
Reasonably anticipated cost shared intangible.	.....	§ 1.482-7(d)(1)(ii).
Relevant business activity .....	.....	§ 1.482-7(g)(7)(i).
Routine contributions	<i>Routine contributions</i> means a controlled participant's contributions to the relevant business activities that are of the same or 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 participants.	§ 1.482-7(g)(4).
Routine platform and operating contributions, and net routine platform and operating contributions.	.....	§ 1.482-7(g)(4)(vii), 7(g)(7)(iii)(C)(4).
Specified payment form .....	.....	§ 1.482-7(h)(3).
Stock-based compensation .....	.....	§ 1.482-7(d)(3).
Stock options .....	.....	§ 1.482-7(d)(3)(i).
Subsequent PCT .....	.....	§ 1.482-7(g)(2)(viii).
Target .....	.....	§ 1.482-7(g)(5)(i).
Tax rate	Reasonably anticipated effective tax rate with respect to the pre-tax income to which the tax rate is being applied. For example, under the income method, this rate would be the reasonably anticipated effective tax rate of the PCT Payor or PCT Payee under the cost sharing alternative or the licensing alternative, as appropriate.	§ 1.482-7(g)(2)(v)(B)(4)(ii), (g)(4)(i)(G).
Trigger PCT .....	.....	§ 1.482-7(i)(6)(i).
Variable input parameter .....	.....	§ 1.482-7(g)(2)(ix)(C).
WACC	<i>WACC</i> means weighted average cost of capital.	§ 1.482-7(i)(6)(iv)(D).

(ii) *Examples.* The following examples illustrate certain definitions in paragraph (j)(1)(i) of this section:

Example 1. Controlled participant. 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 CSA 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 CSA provides that USS will receive the rights to exploit 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 exploit this process in the United States, USS is not a controlled participant because it will not derive a benefit from exploiting the intangible developed under the CSA.

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Example 2. Controlled participants. (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 CSA 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 RAB shares of USP and FS will be 66% and 33 1/3%, respectively, and the parties' agreement provides that USP and FS will reimburse 66% and 33 1/3%, respectively, of the IDCs 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 (j)(1)(i) of this section, because it will not derive any benefits from exploiting cost shared 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 paragraph (a)(3) of this section and §§ 1.482-4(f)(3)(iii) and (4), and 1.482-9, as appropriate. Such consideration must be treated as IDCs incurred by USP and FS in proportion to their RAB shares (that is, 66% and 33 1/3%, respectively). R + D will not be considered to bear any share of the IDCs under the arrangement.

Example 3. Cost shared intangible, reasonably anticipated cost shared intangible. U.S. Parent (USP) has developed and currently exploits an antihistamine, XY, which is manufactured in tablet form. USP enters into a CSA with its wholly-owned foreign subsidiary (FS) to develop XYZ, a new improved version of XY that will be manufactured as a nasal spray. Work under the CSA is fully devoted to developing XYZ, and XYZ is developed. During the development period, XYZ is a reasonably anticipated cost shared intangible under the CSA. Once developed, XYZ is a cost shared intangible under the CSA.

Example 4. Cost shared intangible. The facts are the same as in *Example 3*, except that in the course of developing XYZ, the controlled participants by accident discover ABC, a cure for disease D. ABC is a cost shared intangible under the CSA.

Example 5. Reasonably anticipated benefits. Controlled parties A and B enter into a cost sharing arrangement to develop product and process intangibles for an already existing Product P. Without such intangibles, A and B would each reasonably anticipate revenue, in present value terms, of \$100M from sales of Product P until it became obsolete. With the intangibles, A and B each reasonably anticipate selling the same number of units each

year, but reasonably anticipate that the price will be higher. Because the particular product intangible is more highly regarded in A's market, A reasonably anticipates an increase of \$20M in present value revenue from the product intangible, while B reasonably anticipates only an increase of \$10M. Further, A and B each reasonably anticipate spending an extra \$5M present value in production costs to include the feature embodying the product intangible. Finally, A and B each reasonably anticipate saving \$2M present value in production costs by using the process intangible. A and B reasonably anticipate no other economic effects from exploiting the cost shared intangibles. A's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue (\$20M) plus its reasonably anticipated cost savings (\$2M) minus its reasonably anticipated increased costs (\$5M), which equals \$17M. Similarly, B's reasonably anticipated benefits from exploiting the cost shared intangibles equal its reasonably anticipated increase in revenue (\$10M) plus its reasonably anticipated cost savings (\$2M) minus its reasonably anticipated increased costs (\$5M), which equals \$7M. Thus A's reasonably anticipated benefits are \$17M and B's reasonably anticipated benefits are \$7M.

(2) *Special rules*—(i) *Consolidated group.* For purposes of this section, all members of the same consolidated group shall be treated as one taxpayer. For these purposes, 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.

(ii) *Trade or business.* A participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in a trade or business within the United States solely by reason of its participation in a CSA. See generally § 1.864-2(a).

(iii) *Partnership.* A CSA, or an arrangement to which the Commissioner applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K of the Internal Revenue Code apply. See § 301.7701-1(c) of this chapter.

(3) *Character*—(i) *CST Payments.* CST Payments generally will be considered

the payor's costs of developing intangibles at the location where such development is conducted. For these purposes, IDCs borne directly by a controlled participant that are deductible are deemed to be reduced to the extent of any CST Payments owed to it by other controlled participants pursuant to the CSA. Each cost sharing payment received by a payee will be treated as coming pro rata from payments made by all payors and will be applied pro rata against the deductions for the taxable year that the payee is allowed in connection with the IDCs. Payments received in excess of such deductions will be treated as in consideration for use of the land and tangible property furnished for purposes of the CSA by the payee. For purposes of the research credit determined under section 41, CST Payments among controlled participants will be treated as provided for intra-group transactions in § 1.41-6(i). Any payment made or received by a taxpayer pursuant to an arrangement that the Commissioner determines not to be a CSA will be subject to the provisions of §§ 1.482-1 through 1.482-6 and 1.482-9. 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.

(ii) *PCT Payments.* A PCT Payor's payment required under paragraph (b)(1)(ii) of this section is deemed to be reduced to the extent of any payments owed to it under such paragraph from other controlled participants. Each PCT Payment received by a PCT Payee will be treated as coming pro rata out of payments made by all PCT Payors. PCT Payments will be characterized consistently with the designation of the type of transaction pursuant to paragraphs (c)(3) and (k)(2)(ii)(H) of this section. Depending on such designation, such payments will be treated as either consideration for a transfer of an interest in intangible property or for services.

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

Example 1. U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a CSA to develop a miniature widget, the Small R. Based on RAB shares, USP agrees to bear 40% and FS to bear 60% of the costs

incurred during the term of the agreement. The principal IDCs are operating costs incurred by FS in Country Z of 100X annually, and costs 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. The payment will be treated as a reimbursement of 20X of USP's costs 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 "Information Return of U.S. Persons With Respect to Certain Foreign Corporations" 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 costs incurred by USP in the United States and 95X of arm's length rental charge, as described in paragraph (d)(1)(iii) of this section, for the use of 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 costs and the 7X depreciation deduction attributable to the U.S. facility. The 8X remainder will be treated as rent for the U.S. facility.

Example 3. (i) Four members (A, B, C, and D) of a controlled group form a CSA to develop the next generation technology for their business. Based on RAB shares, 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 values of the platform contributions they respectively own are in the following amounts for the taxable year: A 80X; B 40X; C 30X; and D 30X. The provisional (before offsets) and final PCT Payments 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 PCT Payment equal to the product of 100X (sum of 40X, 30X, and 30X) and A's RAB share of 40%. The second row/first column shows A's provisional PCT receipts equal to the sum of the products of 80X and B's, C's, and D's RAB 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 PCT receipts/payments after offsets. Thus, for the

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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.

(k) *CSA administrative requirements.* A controlled participant meets the requirements of this paragraph if it substantially complies, respectively, with the CSA contractual, documentation, accounting, and reporting requirements of paragraphs (k)(1) through (4) of this section.

(1) *CSA contractual requirements—(i) In general.* A CSA must be recorded in writing in a contract that is contemporaneous with the formation (and any revision) of the CSA and that includes the contractual provisions described in this paragraph (k)(1).

(ii) *Contractual provisions.* The written contract described in this paragraph (k)(1) must include provisions that—

(A) List the controlled participants and any other members of the controlled group that are reasonably anticipated to benefit from the use of the cost shared intangibles, including the address of each domestic entity and the country of organization of each foreign entity;

(B) Describe the scope of the IDA to be undertaken and each reasonably anticipated cost shared intangible or class of reasonably anticipated cost shared intangibles;

(C) Specify the functions and risks that each controlled participant will undertake in connection with the CSA;

(D) Divide among the controlled participants all divisional interests in cost shared intangibles and specify each controlled participant's divisional interest in the cost shared intangibles, as described in paragraphs (b)(1)(iii) and (4) of this section, that it will own and exploit without any further obligation to compensate any other controlled participant for such interest;

(E) Provide a method to calculate the controlled participants' RAB shares, based on factors that can reasonably be expected to reflect the participants' shares of anticipated benefits, and require that such RAB shares must be updated, as described in paragraph (e)(1) of this section (see also paragraph (k)(2)(ii)(F) of this section);

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(F) Enumerate all categories of IDCs to be shared under the CSA;

(G) Specify that the controlled participant must use a consistent method of accounting to determine IDCs and RAB shares, as described in paragraphs (d) and (e) of this section, respectively, and must translate foreign currencies on a consistent basis;

(H) Require the controlled participant to enter into CSTs covering all IDCs, as described in paragraph (b)(1)(i) of this section, in connection with the CSA;

(I) Require the controlled participants to enter into PCTs covering all platform contributions, as described in paragraph (b)(1)(ii) of this section, in connection with the CSA;

(J) Specify the form of payment due under each PCT (or group of PCTs) in existence at the formation (and any revision) of the CSA, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (h) of this section; and

(K) Specify the date on which the CSA is entered into (CSA Start Date) and the duration of the CSA, the conditions under which the CSA may be modified or terminated, and the consequences of a modification or termination (including consequences described under the rules of paragraph (f) of this section).

(iii) *Meaning of contemporaneous—(A) In general.* For purposes of this paragraph (k)(1), a written contractual agreement is contemporaneous with the formation (or revision) of a CSA if, and only if, the controlled participants record the CSA, in its entirety, in a document that they sign and date no later than 60 days after the first occurrence of any IDC described in paragraph (d) of this section to which such agreement (or revision) is to apply.

(B) *Example.* The following example illustrates the principles of this paragraph (k)(1)(iii):

Example. Companies A and B, both of which are members of the same controlled group, commence an IDA on March 1, Year 1. Company A pays the first IDCs in relation to the IDA, as cash salaries to A's research staff, for the staff's work during the first week of March, Year 1. A and B, however, do not sign and date any written contractual agreement

until August 1, Year 1, whereupon they execute a “Cost Sharing Agreement” that purports to be “effective as of” March 1 of Year 1. The arrangement fails the requirement that the participants record their arrangement in a written contractual agreement that is contemporaneous with the formation of a CSA. The arrangement has failed to meet the requirements set forth in paragraph (b)(2) of this section and, pursuant to paragraph (b) of this section, cannot be a CSA.

(iv) *Interpretation of contractual provisions*—(A) *In general*. The provisions of a written contract described in this paragraph (k)(1) and of the additional documentation described in paragraph (k)(2) of this section must be clear and unambiguous. The provisions will be interpreted by reference to the economic substance of the transaction and the actual conduct of the controlled participants. See § 1.482-1(d)(3)(ii)(B) (Identifying contractual terms). Accordingly, the Commissioner may impute contractual terms in a CSA consistent with the economic substance of the CSA and may disregard contractual terms that lack economic substance. An allocation of risk between controlled participants after the outcome of such risk is known or reasonably knowable lacks economic substance. See § 1.482-1(d)(3)(iii)(B) (Identification of taxpayer that bears risk). A contractual term that is disregarded due to a lack of economic substance does not satisfy a contractual requirement set forth in this paragraph (k)(1) or documentation requirement set forth in paragraph (k)(2) of this section. See paragraph (b)(5) of this section for the treatment of an arrangement among controlled taxpayers that fails to comply with the requirements of this section.

(B) *Examples*. The following examples illustrate the principles of this paragraph (k)(1)(iv). In each example, it is assumed that the Commissioner will exercise the discretion granted pursuant to paragraph (b)(5)(ii) of this section to apply the provisions of this section to the arrangement that purports to be a CSA.

Example 1. The contractual provisions recorded upon formation of an arrangement that purports to be a CSA provide that PCT Payments with respect to a particular platform contribution will consist of payments

contingent on sales. Contrary to the contractual provisions, the PCT Payments actually made are contingent on profits. Because the controlled participants’ actual conduct is different from the contractual terms, the Commissioner may determine, based on the facts and circumstances, that—

(i) The actual payments have economic substance and, therefore, impute payment terms in the CSA consistent with the actual payments; or

(ii) The contract terms reflect the economic substance of the arrangement and, therefore, the actual payments must be adjusted to conform to the terms.

Example 2. An arrangement that purports to be a CSA provides that PCT Payments with respect to a particular platform contribution shall be contingent payments equal to 10% of sales of products that incorporate cost shared intangibles. The contract terms further provide that the controlled participants must adjust such contingent payments in accordance with a formula set forth in the terms. During the first three years of the arrangement, the controlled participants fail to make the adjustments required by the terms with respect to the PCT Payments. The Commissioner may determine, based on the facts and circumstances, that—

(i) The contingent payment terms with respect to the platform contribution do not have economic substance because the controlled participants did not act in accordance with their upfront risk allocation; or

(ii) The contract terms reflect the economic substance of the arrangement and, therefore, the actual payments must be adjusted to conform to the terms.

(2) *CSA documentation requirements*—(i) *In general*. The controlled participants must timely update and maintain sufficient documentation to establish that the participants have met the CSA contractual requirements of paragraph (k)(1) of this section and the additional CSA documentation requirements of this paragraph (k)(2).

(ii) *Additional CSA documentation requirements*. The controlled participants to a CSA must timely update and maintain documentation sufficient to—

(A) Describe the current scope of the IDA and identify—

(1) Any additions or subtractions from the list of reasonably anticipated cost shared intangibles reported pursuant to paragraph (k)(1)(ii)(B) of this section;

(2) Any cost shared intangible, together with each controlled participant’s interest therein; and

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(3) Any further development of intangibles already developed under the CSA or of specified applications of such intangible which has been removed from the IDA (see paragraphs (d)(1)(ii) and (j)(1)(i) of this section for the definitions of reasonably anticipated cost shared intangible and cost shared intangible) and the steps (including any accounting classifications and allocations) taken to implement such removal;

(B) Establish that each controlled participant reasonably anticipates that it will derive benefits from exploiting cost shared intangibles;

(C) Describe the functions and risks that each controlled participant has undertaken during the term of the CSA;

(D) Provide an overview of each controlled participant's business segments, including an analysis of the economic and legal factors that affect CST and PCT pricing;

(E) Establish the amount of each controlled participant's IDCs for each taxable year under the CSA, including all IDCs attributable to stock-based compensation, as described in paragraph (d)(3) of this section (including the method of measurement and timing used in determining such IDCs, and the data, as of the date of grant, used to identify stock-based compensation with the IDA);

(F) Describe the method used to estimate each controlled participant's RAB share for each year during the course of the CSA, including—

(1) All projections used to estimate benefits;

(2) All updates of the RAB shares in accordance with paragraph (e)(1) of this section; and

(3) An explanation of why that method was selected and why the method provides the most reliable measure for estimating RAB shares;

(G) Describe all platform contributions;

(H) Designate the type of transaction involved for each PCT or group of PCTs;

(I) Specify, within the time period provided in paragraph (h)(2)(iii) of this section, the form of payment due under each PCT or group of PCTs, including information and explanation that rea-

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sonably supports an analysis of applicable provisions of paragraph (h) of this section;

(J) Describe and explain the method selected to determine the arm's length payment due under each PCT, including—

(1) An explanation of why the method selected constitutes the best method, as described in § 1.482-1(c)(2), for measuring an arm's length result;

(2) The economic analyses, data, and projections relied upon in developing and selecting the best method, including the source of the data and projections used;

(3) Each alternative method that was considered, and the reason or reasons that the alternative method was not selected;

(4) Any data that the controlled participant obtains, after the CSA takes effect, that would help determine if the controlled participant's method selected has been applied in a reasonable manner;

(5) The discount rate or rates, where applicable, used for purposes of evaluating PCT Payments, including information and explanation that reasonably supports an analysis of applicable provisions of paragraph (g)(2)(v) of this section;

(6) The estimated arm's length values of any platform contributions as of the dates of the relevant PCTs, in accordance with paragraph (g)(2)(ii) of this section;

(7) A discussion, where applicable, of why transactions were or were not aggregated under the principles of paragraph (g)(2)(iv) of this section;

(8) The method payment form and any conversion made from the method payment form to the specified payment form, as described in paragraph (h)(3) of this section; and

(9) If applicable under paragraph (i)(6)(iv) of this section, the WACC of the parent of the controlled group that includes the controlled participants.

(iii) *Coordination rules and production of documents*—(A) *Coordination with penalty regulations*. See § 1.6662-6(d)(2)(iii)(D) regarding coordination of the rules of this paragraph (k) with the documentation requirements for purposes of the accuracy-related penalty under section 6662(e) and (h).

(B) *Production of documentation.* Each controlled participant must provide to the Commissioner, within 30 days of a request, the items described in this paragraph (k)(2) and paragraph (k)(3) of this section. The time for compliance described in this paragraph (k)(2)(iii)(B) may be extended at the discretion of the Commissioner.

(3) *CSA accounting requirements—(i) In general.* The controlled participants must maintain books and records (and related or underlying data and information) that are sufficient to—

(A) Establish that the controlled participants have used (and are using) a consistent method of accounting to measure costs and benefits;

(B) Permit verification that the amount of any contingent PCT Payments due have been (and are being) properly determined;

(C) Translate foreign currencies on a consistent basis; and

(D) To the extent that the method of accounting used materially differs from U.S. generally accepted accounting principles, explain any such material differences.

(ii) *Reliance on financial accounting.* For purposes of this section, the controlled participants may not rely solely upon financial accounting to establish satisfaction of the accounting requirements of this paragraph (k)(3). Rather, the method of accounting must clearly reflect income. *Thor Power Tools Co. v. Commissioner*, 439 U.S. 522 (1979).

(4) *CSA reporting requirements—(i) CSA Statement.* Each controlled participant must file with the Internal Revenue Service, in the manner described in this paragraph (k)(4), a “Statement of Controlled Participant to §1.482-7 Cost Sharing Arrangement” (CSA Statement) that complies with the requirements of this paragraph (k)(4).

(ii) *Content of CSA Statement.* The CSA Statement of each controlled participant must—

(A) State that the participant is a controlled participant in a CSA;

(B) Provide the controlled participant's taxpayer identification number;

(C) List the other controlled participants in the CSA, the country of organization of each such participant, and

the taxpayer identification number of each such participant;

(D) Specify the earliest date that any IDC described in paragraph (d)(1) of this section occurred; and

(E) Indicate the date on which the controlled participants formed (or revised) the CSA and, if different from such date, the date on which the controlled participants recorded the CSA (or any revision) contemporaneously in accordance with paragraphs (k)(1)(i) and (iii) of this section.

(iii) *Time for filing CSA Statement—(A) 90-day rule.* Each controlled participant must file its original CSA Statement with the Internal Revenue Service Ogden Campus (addressed as follows: “Attn: CSA Statements, Mail Stop 4912, Internal Revenue Service, 1973 North Rulon White Blvd., Ogden, Utah 84404-0040”), no later than 90 days after the first occurrence of an IDC to which the newly-formed CSA applies, as described in paragraph (k)(1)(iii)(A) of this section, or, in the case of a taxpayer that became a controlled participant after the formation of the CSA, no later than 90 days after such taxpayer became a controlled participant. A CSA Statement filed in accordance with this paragraph (k)(4)(iii)(A) must be dated and signed, under penalties of perjury, by an officer of the controlled participant who is duly authorized (under local law) to sign the statement on behalf of the controlled participant.

(B) *Annual return requirement—(1) In general.* Each controlled participant must attach to its U.S. income tax return, for each taxable year for the duration of the CSA, a copy of the original CSA Statement that the controlled participant filed in accordance with the 90-day rule of paragraph (k)(4)(iii)(A) of this section. In addition, the controlled participant must update the information reflected on the original CSA Statement annually by attaching a schedule that documents changes in such information over time.

(2) *Special filing rule for annual return requirement.* If a controlled participant is not required to file a U.S. income tax return, the participant must ensure that the copy or copies of the CSA Statement and any updates are attached to Schedule M of any Form 5471, any Form 5472 “Information Return of

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a Foreign Owned Corporation," or any Form 8865 "Return of U.S. Persons With Respect to Certain Foreign Partnerships," filed with respect to that participant.

(iv) *Examples.* The following examples illustrate this paragraph (k)(4). In each example, Companies A and B are members of the same controlled group.

Example 1. A and B, both of which file U.S. tax returns, agree to share the costs of developing a new chemical formula in accordance with the provisions of this section. On March 30, Year 1, A and B record their agreement in a written contract styled, "Cost Sharing Agreement." The contract applies by its terms to IDCs occurring after March 1, Year 1. The first IDCs to which the CSA applies occurred on March 15, Year 1. To comply with paragraph (k)(4)(iii)(A) of this section, A and B individually must file separate CSA Statements no later than 90 days after March 15, Year 1 (June 13, Year 1). Further, to comply with paragraph (k)(4)(iii)(B) of this section, A and B must attach copies of their respective CSA Statements to their respective Year 1 U.S. income tax returns.

Example 2. The facts are the same as in *Example 1*, except that a year has passed and C, which files a U.S. tax return, joined the CSA on May 9, Year 2. To comply with the annual filing requirement described in paragraph (k)(4)(iii)(B) of this section, A and B must each attach copies of their respective CSA Statements (as filed for Year 1) to their respective Year 2 income tax returns, along with a schedule updated appropriately to reflect the changes in information described in paragraph (k)(4)(ii) of this section resulting from the addition of C to the CSA. To comply with both the 90-day rule described in paragraph (k)(4)(iii)(A) of this section and the annual filing requirement described in paragraph (k)(4)(iii)(B) of this section, C must file a CSA Statement no later than 90 days after May 9, Year 2 (August 7, Year 2), and must attach a copy of such CSA Statement to its Year 2 income tax return.

(1) *Effective/applicability dates.* Except as otherwise provided in this paragraph (1), this section applies on December 16, 2011. Paragraphs (g)(2)(v)(B)(2), (g)(4)(vi)(F)(2), and (g)(4)(viii), *Example 8* of this section apply to taxable years beginning on or after December 19, 2011. Paragraphs (g)(4)(v) and (g)(4)(viii), *Example 9* apply to taxable years beginning on or after August 27, 2013.

(m) *Transition rule—(1) In general.* An arrangement in existence on January 5, 2009, will be considered a CSA, as described under paragraph (b) of this sec-

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tion, if, prior to such date, it was a qualified cost sharing arrangement under the provisions of §1.482-7 (as contained in the 26 CFR part 1 edition revised as of January 1, 1996, hereafter referred to as "former §1.482-7"), but only if the written contract, as described in paragraph (k)(1) of this section, is amended, if necessary, to conform with, and only if the activities of the controlled participants substantially comply with, the provisions of this section, as modified by paragraphs (m)(2) and (m)(3) of this section, by July 6, 2009.

(2) *Transitional modification of applicable provisions.* For purposes of this paragraph (m), conformity and substantial compliance with the provisions of this section shall be determined with the following modifications:

(i) CSTs and PCTs occurring prior to January 5, 2009, shall be subject to the provisions of former §1.482-7 rather than this section.

(ii) Except to the extent provided in paragraph (m)(3) of this section, PCTs that occur under a CSA that was a qualified cost sharing arrangement under the provisions of former §1.482-7 and remained in effect on January 5, 2009, shall be subject to the periodic adjustment rules of §1.482-4(f)(2) rather than the rules of paragraph (i)(6) of this section.

(iii) Paragraphs (b)(1)(iii) and (b)(4) of this section shall not apply.

(iv) Paragraph (k)(1)(ii)(D) of this section shall not apply.

(v) Paragraphs (k)(1)(ii)(H) and (I) of this section shall be construed as applying only to transactions entered into on or after January 5, 2009.

(vi) The deadline for recordation of the revised written contractual agreement pursuant to paragraph (k)(1)(iii) of this section shall be no later than July 6, 2009.

(vii) Paragraphs (k)(2)(ii)(G) through (J) of this section shall be construed as applying only with reference to PCTs entered into on or after January 5, 2009.

(viii) Paragraph (k)(4)(iii)(A) of this section shall be construed as requiring a CSA Statement with respect to the revised written contractual agreement described in paragraph (m)(2)(vi) of this section no later than September 2, 2009.

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(ix) Paragraph (k)(4)(iii)(B) of this section shall be construed as only applying for taxable years ending after the filing of the CSA Statement described in paragraph (m)(2)(viii) of this section.

(3) *Special rule for certain periodic adjustments.* The periodic adjustment rules in paragraph (i)(6) of this section (rather than the rules of §1.482-4(f)(2)) shall apply to PCTs that occur on or after the date of a material change in the scope of the CSA from its scope as of January 5, 2009. A material change in scope would include a material expansion of the activities undertaken beyond the scope of the intangible development area, as described in former §1.482-7(b)(4)(iv). For this purpose, a contraction of the scope of a CSA, absent a material expansion into one or more lines of research and development beyond the scope of the intangible development area, does not constitute a material change in scope of the CSA. Whether a material change in scope has occurred is determined on a cumulative basis. Therefore, a series of expansions, any one of which is not a material expansion by itself, may collectively constitute a material expansion.

[T.D. 9568, 76 FR 80090, Dec. 22, 2011, as amended by T.D. 9569, 76 FR 80250, Dec. 23, 2011; 77 FR 3606, Jan. 25, 2012, 77 FR 8814, Feb. 14, 2012; T.D. 9630, 78 FR 52855, Aug. 27, 2013; 78 FR 62426, Oct. 22, 2013]

§ 1.482-8 Examples of the best method rule.

(a) *Introduction.* 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.

(b) *Examples.*

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.

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(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

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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.

Example 10. Cost of services plus method preferred to other methods. (i) FP designs and manufactures consumer electronic devices that incorporate advanced technology. In year 1, FP introduces Product X, an entertainment device targeted primarily at the youth market. FP's wholly-owned, exclusive U.S. distributor, USSub, sells Product X in the U.S. market. USSub hires an independent marketing firm, Agency A, to promote Product X in the U.S. market. Agency A has successfully promoted other electronic products on behalf of other uncontrolled parties. USSub executes a one-year, renewable

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contract with Agency A that requires it to develop the market for Product X, within an annual budget set by USSub. In years 1 through 3, Agency A develops advertising, buys media, and sponsors events featuring Product X. Agency A receives a markup of 25% on all expenses of promoting Product X, with the exception of media buys, which are reimbursed at cost. During year 3, sales of Product X decrease sharply, as Product X is displaced by competitors' products. At the end of year 3, sales of Product X are discontinued.

(ii) Prior to the start of year 4, FP develops a new entertainment device, Product Y. Like Product X, Product Y is intended for sale to the youth market, but it is marketed under a new trademark distinct from that used for Product X. USSub decides to perform all U.S. market promotion for Product Y. USSub hires key Agency A staff members who handled the successful Product X campaign. To promote Product Y, USSub intends to use methods similar to those used successfully by Agency A to promote Product X (print advertising, media, event sponsorship, etc.). FP and USSub enter into a one-year, renewable agreement concerning promotion of Product Y in the U.S. market. Under the agreement, FP compensates USSub for promoting Product Y, based on a cost of services plus markup of A%. Third-party media buys by USSub in connection with Product Y are reimbursed at cost.

(iii) Assume that under the contractual arrangements between FP and USSub, the arm's length consideration for Product Y and the trademark or other intangible property may be determined reliably under one or more transfer pricing methods. At issue in this example is the separate evaluation of the arm's length compensation for the year 4 promotional activities performed by USSub pursuant to its contract with FP.

(iv) USSub's accounting records contain reliable data that separately state the costs incurred to promote Product Y. A functional analysis indicates that USSub's activities to promote Product Y in year 4 are similar to activities performed by Agency A during years 1 through 3 under the contract with USSub. In other respects, no material differences exist in the market conditions or the promotional activities performed in year 4, as compared to those in years 1 through 3.

(v) It is possible to identify uncontrolled distributors or licensees of electronic products that perform, as one component of their business activities, promotional activities similar to those performed by USSub. However, it is unlikely that publicly available accounting data from these companies would allow computation of the comparable transactional costs or total services costs associated with the marketing or promotional activities that these entities perform, as one component of business activities. If that

were possible, the comparable profits method for services might provide a reliable measure of an arm's length result. The functional analysis of the marketing activities performed by USSub in year 4 indicates that they are similar to the activities performed by Agency A in years 1 through 3 for Product X. Because reliable information is available concerning the markup on costs charged in a comparable uncontrolled transaction, the most reliable measure of an arm's length price is the cost of services plus method in § 1.482-9(e).

Example 11. CPM for services preferred to other methods. (i) FP manufactures furniture and accessories for residential use. FP sells its products to retailers in Europe under the trademark, "Moda." FP holds all worldwide rights to the trademark, including in the United States. USSub is FP's wholly-owned subsidiary in the U.S. market and the exclusive U.S. distributor of FP's merchandise. Historically, USSub dealt only with specialized designers in the U.S. market and advertised in trade publications targeted to this market. Although items sold in the U.S. and Europe are physically identical, USSub's U.S. customers generally resell the merchandise as non-branded merchandise.

(ii) FP retains an independent firm to evaluate the feasibility of selling FP's trademarked merchandise in the general wholesale and retail market in the United States. The study concludes that this segment of the U.S. market, which is not exploited by USSub, may generate substantial profits. Based on this study, FP enters into a separate agreement with USSub, which provides that USSub will develop this market in the United States for the benefit of FP. USSub separately accounts for personnel expenses, overhead, and out-of-pocket costs attributable to the initial stage of the marketing campaign (Phase I). USSub receives as compensation its costs, plus a markup of X%, for activities in Phase I. At the end of Phase I, FP will evaluate the program. If success appears likely, USSub will begin full-scale distribution of trademarked merchandise in the new market segment, pursuant to agreements negotiated with FP at that time.

(iii) Assume that under the contractual arrangements in effect between FP and USSub, the arm's length consideration for the merchandise and the trademark or other intangible property may be determined reliably under one or more transfer pricing methods. At issue in this example is the separate evaluation of the arm's length compensation for the marketing activities conducted by USSub in years 1 and following.

(iv) A functional analysis reveals that USSub's activities consist primarily of modifying the promotional materials created by FP, negotiating media buys, and arranging promotional events. FP separately com-

pensates USSub for all Phase I activities, and detailed accounting information is available regarding the costs of these activities. The Phase I activities of USSub are similar to those of uncontrolled companies that perform, as their primary business activity, a range of advertising and media relations activities on a contract basis for uncontrolled parties.

(v) No information is available concerning the comparable uncontrolled prices for services in transactions similar to those engaged in by FP and USSub. Nor is any information available concerning uncontrolled transactions that would allow application of the cost of services plus method. It is possible to identify uncontrolled distributors or licensees of home furnishings that perform, as one component of their business activities, promotional activities similar to those performed by USSub. However, it is unlikely that publicly available accounting data from these companies would allow computation of the comparable transactional costs or total services costs associated with the marketing or promotional activities that these entities performed, as one component of their business activities. On the other hand, it is possible to identify uncontrolled advertising and media relations companies, the principal business activities of which are similar to the Phase I activities of USSub. Under these circumstances, the most reliable measure of an arm's length price is the comparable profits method of § 1.482-9(f). The uncontrolled advertising comparables' treatment of material items, such as classification of items as cost of goods sold or selling, general, and administrative expenses, may differ from that of USSub. Such inconsistencies in accounting treatment between the uncontrolled comparables and the tested party, or among the comparables, are less important when using the ratio of operating profit to total services costs under the comparable profits method for services in § 1.482-9(f). Under this method, the operating profit of USSub from the Phase I activities is compared to the operating profit of uncontrolled parties that perform general advertising and media relations as their primary business activity.

Example 12. Residual profit split preferred to other methods. (i) USP is a manufacturer of athletic apparel sold under the AA trademark, to which FP owns the worldwide rights. USP sells AA trademark apparel in countries throughout the world, but prior to year 1, USP did not sell its merchandise in Country X. In year 1, USP acquires an uncontrolled Country X company which becomes its wholly-owned subsidiary, XSub. USP enters into an exclusive distribution arrangement with XSub in Country X. Before being acquired by USP in year 1, XSub distributed athletic apparel purchased from uncontrolled suppliers and resold that merchandise to retailers. After being acquired by

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USP in year 1, XSub continues to distribute merchandise from uncontrolled suppliers and also begins to distribute AA trademark apparel. Under a separate agreement with USP, XSub uses its best efforts to promote the AA trademark in Country X, with the goal of maximizing sales volume and revenues from AA merchandise.

(ii) Prior to year 1, USP executed long-term endorsement contracts with several prominent professional athletes. These contracts give USP the right to use the names and likenesses of the athletes in any country in which AA merchandise is sold during the term of the contract. These contracts remain in effect for five years, starting in year 1. Before being acquired by USP, XSub renewed a long-term agreement with SportMart, an uncontrolled company that owns a nationwide chain of sporting goods retailers in Country X. XSub has been SportMart's primary supplier from the time that SportMart began operations. Under the agreement, SportMart will provide AA merchandise preferred shelf-space and will feature AA merchandise at no charge in its print ads and seasonal promotions. In consideration for these commitments, USP and XSub grant SportMart advance access to new products and the right to use the professional athletes under contract with USP in SportMart advertisements featuring AA merchandise (subject to approval of content by USP).

(iii) Assume that it is possible to segregate all transactions by XSub that involve distribution of merchandise acquired from uncontrolled distributors (non-controlled transactions). In addition, assume that, apart from the activities undertaken by USP and XSub to promote AA apparel in Country X, the arm's length compensation for other functions performed by USP and XSub in the Country X market in years 1 and following can be reliably determined. At issue in this *Example 12* is the application of the residual profit split analysis to determine the appropriate division between USP and XSub of the balance of the operating profits from the Country X market, that is the portion attributable to nonroutine contributions to the marketing and promotional activities.

(iv) A functional analysis of the marketing and promotional activities conducted in the Country X market, as described in this example, indicates that both USP and XSub made nonroutine contributions to the business activity. USP contributed the long-term endorsement contracts with professional athletes. XSub contributed its long-term contractual rights with SportMart, which were made more valuable by its successful, long-term relationship with SportMart.

(v) Based on the facts and circumstances, including the fact that both USP and XSub made valuable nonroutine contributions to the marketing and promotional activities and an analysis of the availability (or lack

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thereof) of comparable and reliable market benchmarks, the Commissioner determines that the most reliable measure of an arm's length result is the residual profit split method in § 1.482-9(g). The residual profit split analysis would take into account both routine and nonroutine contributions by USP and XSub, in order to determine an appropriate allocation of the combined operating profits in the Country X market from the sale of AA merchandise and from related promotional and marketing activities.

Example 13. Preference for acquisition price method. (i) USP develops, manufacturers, and distributes pharmaceutical products. USP and FS, USP's wholly-owned subsidiary, enter into a CSA to develop a new oncological drug, Oncol. Immediately prior to entering into the CSA, USP acquires Company X, an unrelated U.S. pharmaceutical company. Company X is solely engaged in oncological pharmaceutical research, and its only significant resources and capabilities are its workforce and its sole patent, which is associated with Compound X, a promising molecular compound derived from a rare plant, which USP reasonably anticipates will contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to developing Oncol as well. The rights in the Compound X and the commitment of Company X's researchers to the development of Oncol are platform contributions for which compensation is due from FS as part of a PCT.

(ii) In this case, the acquisition price method, based on the lump sum price paid by USP for Company X, is likely to provide a more reliable measure of an arm's length PCT Payment due to USP than the application of any other method. See §§ 1.482-4(c)(2) and 1.482-7(g)(5)(iv)(A).

Example 14. Preference for market capitalization method. (i) Company X is a publicly traded U.S. company solely engaged in oncological pharmaceutical research and its only significant resources and capabilities are its workforce and its sole patent, which is associated with Compound Y, a promising molecular compound derived from a rare plant. Company X has no marketable products. Company X enters into a CSA with FS, a newly-formed foreign subsidiary, to develop a new oncological drug, Oncol, derived from Compound Y. Compound Y is reasonably anticipated to contribute to developing Oncol. All of Company X researchers will be engaged solely in research that is reasonably anticipated to contribute to developing Oncol under the CSA. The rights in Compound Y and the commitment of Company X's researchers are platform contributions for which compensation is due from FS as part of a PCT.

(ii) In this case, given that Company X's platform contributions covered by PCTs relate to its entire economic value, the application of the market capitalization method, based on the market capitalization of Company X, provides a reliable measure of an arm's length result for Company X's PCTs to the CSA. See §§1.482-4(c)(2) and 1.482-7(g)(6)(v)(A).

Example 15. Preference for market capitalization method. (i) MicroDent, Inc. (MDI) is a publicly traded company that developed a new dental surgical microscope ScopeX-1, which drastically shortens many surgical procedures. On January 1 of Year 1, MDI entered into a CSA with a wholly-owned foreign subsidiary (FS) to develop ScopeX-2, the next generation of ScopeX-1. In the CSA, divisional interests are divided on a territorial basis. The rights associated with ScopeX-1, as well as MDI's research capabilities are reasonably anticipated to contribute to the development of ScopeX-2 and are therefore platform contributions for which compensation is due from FS as part of a PCT. At the time of the PCT, MDI's only product was the ScopeX-1 microscope, although MDI was in the process of developing ScopeX-2. Concurrent with the CSA, MDI separately transfers exclusive and perpetual exploitation rights associated with ScopeX-1 to FS in the same territory as assigned to FS in the CSA.

(ii) Although the transactions between MDI and FS under the CSA are distinct from the transactions between MDI and FS relating to the exploitation rights for ScopeX-1, it is likely to be more reliable to evaluate the combined effect of the transactions than to evaluate them in isolation. This is because the combined transactions between MDI and FS relate to all of the economic value of MDI (that is, the exploitation rights and research rights associated with ScopeX-1, as well as the research capabilities of MDI). In this case, application of the market capitalization method, based on the enterprise value of MDI on January 1 of Year 1, is likely to provide a reliable measure of an arm's length payment for the aggregated transactions. See §§1.482-4(c)(2) and 1.482-7(g)(6)(v)(A).

(iii) Notwithstanding that the market capitalization method provides the most reliable measure of the aggregated transactions between MDI and FS, see §1.482-7(g)(2)(iv) for further considerations of when further analysis may be required to distinguish between the remuneration to MDI associated with PCTs under the CSA (for research rights and capabilities associated with ScopeX-1) and the remuneration to MDI for the exploitation rights associated with ScopeX-1.

Example 16. Income method (applied using CPM) preferred to acquisition price method. The facts are the same as in *Example 13*, except that the acquisition occurred significantly in

advance of formation of the CSA, and reliable adjustments cannot be made for this time difference. In addition, Company X has other valuable molecular patents and associated research capabilities, apart from Compound X, that are not reasonably anticipated to contribute to the development of Oncol and that cannot be reliably valued. The CSA divides divisional interests on a territorial basis. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its territory (the United States). FS will distribute Oncol in its territory (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. FS does not furnish any platform contributions. At the time of the PCT, reliable (ex ante) financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken. In this case, application of the income method using CPM is likely to provide a more reliable measure of an arm's length result than application of the acquisition price method based on the price paid by USP for Company X. See §1.482-7(g)(4)(vi) and (5)(iv)(C).

Example 17. Evaluation of alternative methods. (i) The facts are the same as in *Example 13*, except that the acquisition occurred sometime prior to the CSA, and Company X has some areas of promising research that are not reasonably anticipated to contribute to developing Oncol. For purposes of this example, the CSA is assumed to divide divisional interests on a territorial basis. In general, the Commissioner determines that the acquisition price data is useful in informing the arm's length price, but not necessarily determinative. Under the terms of the CSA, USP will undertake all R&D (consisting of laboratory research and clinical testing) and manufacturing associated with Oncol, as well as the distribution activities for its territory (the United States). FS will distribute Oncol in its territory (the rest of the world). FS's distribution activities are routine in nature, and the profitability from its activities may be reliably determined from third-party comparables. At the time of the PCT, financial projections associated with the development of Oncol and its separate exploitation in each of USP's and FSub's assigned geographical territories are undertaken.

(ii) Under the facts, it is possible that the acquisition price method or the income method using CPM might reasonably be applied. Whether the acquisition price method or the income method provides the most reliable evidence of the arm's length price of USP's contributions depends on a number of

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factors, including the reliability of the financial projections, the reliability of the discount rate chosen, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the in-process research done by Company X that does not constitute platform contributions to the CSA. See § 1.482-7(g)(4)(vi) and (5)(iv)(A) and (C).

Example 18. Evaluation of alternative methods. (i) The facts are the same as in *Example 17*, except that FS has a patent on Compound Y, which the parties reasonably anticipate will be useful in mitigating potential side effects associated with Compound X and thereby contribute to the development of Oncol. The rights in Compound Y constitute a platform contribution for which compensation is due from USP as part of a PCT. The value of FS's platform contribution cannot be reliably measured by market benchmarks.

(ii) Under the facts, it is possible that either the acquisition price method and the income method together or the residual profit split method might reasonably be applied to determine the arm's length PCT Payments due between USP and FS. Under the first option the PCT Payment for the platform contributions related to Company X's workforce and Compound X would be determined using the acquisition price method referring to the lump sum price paid by USP for Company X. Because the value of these platform contributions can be determined by reference to a market benchmark, they are considered routine platform contributions. Accordingly, under this option, the platform contribution related to Compound Y would be the only nonroutine platform contribution and the relevant PCT Payment is determined using the income method. Under the second option, rather than looking to the acquisition price for Company X, all the platform contributions are considered nonroutine and the RPSM is applied to determine the PCT Payments for each platform contribution. Under either option, the PCT Payments will be netted against each other.

(iii) Whether the acquisition price method together with the income method or the residual profit split method provides the most reliable evidence of the arm's length price of the platform contributions of USP and FS depends on a number of factors, including the reliability of the determination of the relative values of the platform contributions for purposes of the RPSM, and the extent to which the acquisition price of Company X can be reliably adjusted to account for changes in value over the time period between the acquisition and the formation of the CSA and to account for the value of the rights in the in-process research done by Company X that does not constitute plat-

form contributions to the CSA. In these circumstances, it is also relevant to consider whether the results of each method are consistent with each other, or whether one or both methods are consistent with other potential methods that could be applied. See § 1.482-7(g)(4)(vi), (5)(iv), and (7)(iv).

(c) *Effective/applicability date*—(1) *In general.* Paragraphs (a) and (b) *Examples 10 through 12* of this section are generally applicable for taxable years beginning after December 31, 2006. Paragraph (b) *Examples 13 through 18* of this section are generally applicable on January 5, 2009.

(2) *Election to apply regulation to earlier taxable years.* A person may elect to apply the provisions of paragraph (b) *Examples 10, 11, and 12* of this section to earlier taxable years in accordance with the rules set forth in § 1.482-9(n)(2).

[T.D. 8552, 59 FR 35028, July 8, 1994, as amended by T.D. 9278, 71 FR 44487, Aug. 4, 2006; T.D. 9441, 74 FR 388, Jan. 5, 2009; T.D. 9456, 74 FR 38845, Aug. 4, 2009; 74 FR 46346, Sept. 9, 2009; T.D. 9568, 76 FR 80134, Dec. 22, 2011]

§ 1.482-9 Methods to determine taxable income in connection with a controlled services transaction.

(a) *In general.* The arm's length amount charged in a controlled services transaction must be determined under one of the methods provided for in this section. Each method must be applied in accordance with 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), except as those provisions are modified in this section. The methods are—

(1) The services cost method, described in paragraph (b) of this section;

(2) The comparable uncontrolled services price method, described in paragraph (c) of this section;

(3) The gross services margin method, described in paragraph (d) of this section;

(4) The cost of services plus method, described in paragraph (e) of this section;

(5) The comparable profits method, described in § 1.482-5 and in paragraph (f) of this section;

(6) The profit split method, described in § 1.482-6 and in paragraph (g) of this section; and

(7) Unspecified methods, described in paragraph (h) of this section.

(b) *Services cost method*—(1) *In general*. The services cost method evaluates whether the amount charged for certain services is arm's length by reference to the total services costs (as defined in paragraph (j) of this section) with no markup. If a taxpayer applies the services cost method in accordance with the rules of this paragraph (b), then it will be considered the best method for purposes of §1.482-1(c), and the Commissioner's allocations will be limited to adjusting the amount charged for such services to the properly determined amount of such total services costs.

(2) *Eligibility for the services cost method*. To apply the services cost method to a service in accordance with the rules of this paragraph (b), all of the following requirements must be satisfied with respect to the service—

(i) The service is a covered service as defined in paragraph (b)(3) of this section;

(ii) The service is not an excluded activity as defined in paragraph (b)(4) of this section;

(iii) The service is not precluded from constituting a covered service by the business judgment rule described in paragraph (b)(5) of this section; and

(iv) Adequate books and records are maintained as described in paragraph (b)(6) of this section.

(3) *Covered services*. For purposes of this paragraph (b), covered services consist of a controlled service transaction or a group of controlled service transactions (see §1.482-1(f)(2)(i) (aggregation of transactions)) that meet the definition of specified covered services or low margin covered services.

(i) *Specified covered services*. Specified covered services are controlled services transactions that the Commissioner specifies by revenue procedure. Services will be included in such revenue procedure based upon the Commissioner's determination that the specified covered services are support services common among taxpayers across industry sectors and generally do not involve a significant median comparable markup on total services costs. For the definition of the median comparable markup on total services costs,

see paragraph (b)(3)(ii) of this section. The Commissioner may add to, subtract from, or otherwise revise the specified covered services described in the revenue procedure by subsequent revenue procedure, which amendments will ordinarily be prospective only in effect.

(ii) *Low margin covered services*. Low margin covered services are controlled services transactions for which the median comparable markup on total services costs is less than or equal to seven percent. For purposes of this paragraph (b), the median comparable markup on total services costs means the excess of the arm's length price of the controlled services transaction determined under the general section 482 regulations without regard to this paragraph (b), using the interquartile range described in §1.482-1(e)(2)(iii)(C) and as necessary adjusting to the median of such interquartile range, over total services costs, expressed as a percentage of total services costs.

(4) *Excluded activity*. The following types of activities are excluded activities:

(i) Manufacturing.

(ii) Production.

(iii) Extraction, exploration, or processing of natural resources.

(iv) Construction.

(v) Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement.

(vi) Research, development, or experimentation.

(vii) Engineering or scientific.

(viii) Financial transactions, including guarantees.

(ix) Insurance or reinsurance.

(5) *Not services that contribute significantly to fundamental risks of business success or failure*. A service cannot constitute a covered service unless the taxpayer reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group, as defined in §1.482-1(i)(6). In evaluating the reasonableness of the conclusion

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required by this paragraph (b)(5), consideration will be given to all the facts and circumstances.

(6) *Adequate books and records.* Permanent books of account and records are maintained for as long as the costs with respect to the covered services are incurred by the renderer. Such books and records must include a statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for such services. Such books and records must be adequate to permit verification by the Commissioner of the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of such services, and sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services in question in accordance with paragraph (k) of this section.

(7) *Shared services arrangement*—(i) *In general.* If the services cost method is used to evaluate the amount charged for covered services, and such services are the subject of a shared services arrangement, then the arm's length charge to each participant for such services will be the portion of the total costs of the services otherwise determined under the services cost method of this paragraph (b) that is properly allocated to such participant pursuant to the arrangement.

(ii) *Requirements for shared services arrangement.* A shared services arrangement must meet the requirements described in this paragraph (b)(7).

(A) *Eligibility.* To be eligible for treatment under this paragraph (b)(7), a shared services arrangement must—

(1) Include two or more participants;

(2) Include as participants all controlled taxpayers that reasonably anticipate a benefit (as defined under paragraph (l)(3)(i) of this section) from one or more covered services specified in the shared services arrangement; and

(3) Be structured such that each covered service (or each reasonable aggregation of services within the meaning of paragraph (b)(7)(iii)(B) of this section) confers a benefit on at least one

participant in the shared services arrangement.

(B) *Allocation.* The costs for covered services must be allocated among the participants based on their respective shares of the reasonably anticipated benefits from those services, without regard to whether the anticipated benefits are in fact realized. Reasonably anticipated benefits are benefits as defined in paragraph (l)(3)(i) of this section. The allocation of costs must provide the most reliable measure of the participants' respective shares of the reasonably anticipated benefits under the principles of the best method rule. *See* §1.482-1(c). The allocation must be applied on a consistent basis for all participants and services. The allocation to each participant in each taxable year must reasonably reflect that participant's respective share of reasonably anticipated benefits for such taxable year. If the taxpayer reasonably concluded that the shared services arrangement (including any aggregation pursuant to paragraph (b)(7)(iii)(B) of this section) allocated costs for covered services on a basis that most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to such services, as provided for in this paragraph (b)(7), then the Commissioner may not adjust such allocation basis.

(C) *Documentation.* The taxpayer must maintain sufficient documentation to establish that the requirements of this paragraph (b)(7) are satisfied, and include—

(1) A statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for covered services pursuant to a shared services arrangement;

(2) A list of the participants and the renderer or renderers of covered services under the shared services arrangement;

(3) A description of the basis of allocation to all participants, consistent with the participants' respective shares of reasonably anticipated benefits; and

(4) A description of any aggregation of covered services for purposes of the shared services arrangement, and an indication whether this aggregation (if any) differs from the aggregation used

to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(3)(ii) of this section.

(iii) *Definitions and special rules*—(A) *Participant*. A participant is a controlled taxpayer that reasonably anticipates benefits from covered services subject to a shared services arrangement that substantially complies with the requirements described in this paragraph (b)(7).

(B) *Aggregation*. Two or more covered services may be aggregated in a reasonable manner taking into account all the facts and circumstances, including whether the relative magnitude of reasonably anticipated benefits of the participants sharing the costs of such aggregated services may be reasonably reflected by the allocation basis employed pursuant to paragraph (b)(7)(ii)(B) of this section. The aggregation of services under a shared services arrangement may differ from the aggregation used to evaluate the median comparable markup for any low margin covered services described in paragraph (b)(3)(ii) of this section, provided that such alternative aggregation can be implemented on a reasonable basis, including appropriately identifying and isolating relevant costs, as necessary.

(C) *Coordination with cost sharing arrangements*. To the extent that an allocation is made to a participant in a shared services arrangement that is also a participant in a cost sharing arrangement subject to § 1.482-7T, such amount with respect to covered services is first allocated pursuant to the shared services arrangement under this paragraph (b)(7). Costs allocated pursuant to a shared services arrangement may (if applicable) be further allocated between the intangible property development activity under § 1.482-7T and other activities of the participant.

(8) *Examples*. The application of this section is illustrated by the following examples. No inference is intended whether the presence or absence of one or more facts is determinative of the conclusion in any example. For purposes of Examples 1 through 14, assume that Company P and its subsidiaries, Company Q and Company R, are corporations and members of the same

group of controlled entities (PQR Controlled Group). For purposes of *Example 15*, assume that Company P and its subsidiary, Company S, are corporations and members of the same group of controlled entities (PS Controlled Group). For purposes of *Examples 16* through 24, assume that Company P and its subsidiaries, Company X, Company Y, and Company Z, are corporations and members of the same group of controlled entities (PXYZ Group) and that Company P and its subsidiaries satisfy all of the requirements for a shared services arrangement specified in paragraphs (b)(7)(ii) and (iii) of this section.

Example 1. Data entry services. (i) Company P, Company Q, and Company R own and operate hospitals. Each owns an electronic database of medical information gathered by doctors and nurses during interviews and treatment of its patients. All three databases are maintained and updated by Company P's administrative support employees who perform data entry activities by entering medical information from the paper records of Company P, Company Q, and Company R into their respective databases.

(ii) Assume that these services relating to data entry are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 2. Data entry services. (i) Company P, Company Q, and Company R specialize in data entry, data processing, and data conversion. Company Q and Company R's data entry activities involve converting medical information data contained in paper records to a digital format. Company P specializes in data entry activities. This specialization reflects, in part, proprietary quality control systems and specially trained data entry experts used to ensure the highest degree of accuracy of data entry services. Company P is engaged by Company Q and Company R to perform these data entry activities for them. Company Q and Company R then charge their customers for the data entry activities performed by Company P.

(ii) Assume that these services performed by Company P relating to data entry are

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specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 3. Recruiting services. (i) Company P, Company Q, and Company R are manufacturing companies that sell their products to unrelated retail establishments. Company P's human resources department recruits mid-level managers and engineers for itself as well as for Company Q and Company R by attending job fairs and other recruitment events. For recruiting higher-level managers and engineers, each of these companies uses recruiters from unrelated executive search firms.

(ii) Assume that these services relating to recruiting are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 4. Recruiting services. (i) Company Q and Company R are executive recruiting service companies that are hired by other companies to recruit professionals. Company P is a recruiting agency that is engaged by Company Q and Company R to perform recruiting activities on their behalf in certain geographic areas.

(ii) Assume that the services performed by Company P are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 5. Credit analysis services. (i) Company P is a manufacturer and distributor of clothing for retail stores. Company Q and Company R are distributors of clothing for retail stores. As part of its operations, personnel in Company P perform credit analysis

on its customers. Most of the customers have a history of purchases from Company P, and the credit analysis involves a review of the recent payment history of the customer's account. For new customers, the personnel in Company P perform a basic credit check of the customer using reports from a credit reporting agency. On behalf of Company Q and Company R, Company P performs credit analysis on customers who order clothing from Company Q and Company R using the same method as Company P uses for itself.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 6. Credit analysis services. (i) Company P, Company Q, and Company R lease furniture to retail customers who present a significant credit risk and are generally unable to lease furniture from other providers. As part of its leasing operations, personnel in Company P perform credit analysis on each of the potential lessees. The personnel have developed special expertise in determining whether a particular customer who presents a significant credit risk (as indicated by credit reporting agencies) will be likely to make the requisite lease payments on a timely basis. Also, as part of its operations, Company P performs similar credit analysis services for Company Q and Company R, which charge correspondingly high monthly lease payments.

(ii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 7. Credit analysis services. (i) Company P is a large full-service bank, which provides products and services to corporate and consumer markets, including unsecured loans, secured loans, lines of credit, letters of credit, conversion of foreign currency, consumer loans, trust services, and sales of certificates of deposit. Company Q makes

routine consumer loans to individuals, such as auto loans and home equity loans. Company R makes only business loans to small businesses.

(ii) Company P performs credit analysis and prepares credit reports for itself, as well as for Company Q and Company R. Company P, Company Q and Company R regularly employ these credit reports in the ordinary course of business in making decisions regarding extensions of credit to potential customers (including whether to lend, rate of interest, and loan terms).

(iii) Assume that these services relating to credit analysis are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the credit analysis services constitute part of a "financial transaction" described in paragraph (b)(4)(viii) of this section. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 8. Data verification services. (i) Company P, Company Q and Company R are manufacturers of industrial supplies. Company P's accounting department performs periodic reviews of the accounts payable information of Company P, Company Q and Company R, and identifies any inaccuracies in the records, such as double-payments and double-charges.

(ii) Assume that these services relating to verification of data are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 9. Data verification services. (i) Company P gathers and inputs information regarding accounts payable and accounts receivable from unrelated parties and utilizes its own computer system to analyze that information for purposes of identifying errors in payment and receipts (data mining). Company P is compensated for these services based on a fee that reflects a percentage of amounts collected by customers as a result of the data mining services. These activities constitute a significant portion of Company P's business. Company P performs similar activities for Company Q and Company R by analyzing their accounts payable and accounts receivable records.

(ii) Assume that these services relating to data mining are specified covered services within the meaning of paragraph (b)(3)(i) of

this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 10. Legal services. (i) Company P is a domestic corporation with two wholly-owned foreign subsidiaries, Company Q and Company R. Company P and its subsidiaries manufacture and distribute equipment used by industrial customers. Company P maintains an in-house legal department consisting of attorneys experienced in a wide range of business and commercial matters. Company Q and Company R maintain small legal departments, consisting of attorneys experienced in matters that most frequently arise in the normal course of business of Company Q and Company R in their respective jurisdictions.

(ii) Company P seeks to maintain in-house legal staff with the ability to address the majority of legal matters that arise in the United States with respect to the operations of Company P, as well as any U.S. reporting or compliance obligations of Company Q or Company R. These include the preparation and review of corporate contracts relating to, for example, product sales, equipment purchases and leases, business liability insurance, real estate, employee salaries and benefits. Company P relies on outside attorneys for major business transactions and highly technical matters such as patent licenses. The in-house legal staffs of Company Q and Company R are much more limited. It is necessary for Company P to retain several local law firms to handle litigation and business disputes arising from the activities of Company Q and Company R. Although Company Q and Company R pay the fees of these law firms, the hiring authority and general oversight of the firms' representation is in the legal department of Company P.

(iii) In determining what portion of the legal expenses of Company P may be allocated to Company Q and Company R, Company P first excludes any expenses relating to legal services that constitute shareholder activities and other items that are not properly analyzed as controlled services. Assume that the remaining services relating to general legal functions performed by in-house legal counsel are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these latter services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or

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failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 11. Legal services. (i) Company P is a domestic holding company whose operating companies, Company Q and Company R, generate electric power for consumers by operating nuclear plants. Assume that, although Company P owns 100% of the stock of Companies Q and R, the companies do not elect to file a consolidated Federal income tax return with Company P.

(ii) Company P maintains an in-house legal department that includes attorneys who are experts in the areas of Federal utilities regulation, Federal labor and environmental law, and securities law. Companies Q and R maintain their own, smaller in-house legal staffs comprising experienced attorneys in the areas of state and local utilities regulation, state labor and employment law, and general commercial law. The legal department of Company P performs general oversight of the legal affairs of the company and determines whether a particular matter would be more efficiently handled by the Company P legal department, by the legal staffs in the operating companies, or in rare cases, by retained outside counsel. In general, Company P has succeeded in minimizing duplication and overlap of functions between the legal staffs of the various companies or by retained outside counsel.

(iii) The domestic nuclear power plant operations of Companies Q and R are subject to extensive regulation by the U.S. Nuclear Regulatory Commission (NRC). Operators are required to obtain pre-construction approval, operating licenses, and, at the end of the operational life of the nuclear reactor, nuclear decommissioning certificates. Company P files consolidated financial statements on behalf of itself, as well as Companies Q and R, with the United States Securities and Exchange Commission (SEC). In these SEC filings, Company P discloses that failure to obtain any of these licenses (and the related periodic renewals) or agreeing to licenses on terms less favorable than those granted to competitors would have a material adverse impact on the operations of Company Q or Company R. Company Q and Company R do not have in-house legal staff with experience in the NRC area. Company P maintains a group of in-house attorneys with specialized expertise in the NRC area that exclusively represents Company Q and Company R before the NRC. Although Company P occasionally hires an outside law firm or industry expert to assist on particular NRC matters, the majority of the work is performed by the specialized legal staff of Company P.

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(iv) Certain of the legal services performed by Company P constitute duplicative or shareholder activities that do not confer a benefit on the other companies and therefore do not need to be allocated to the other companies, while certain other legal services are eligible to be charged to Company Q and Company R in accordance with the services cost method.

(v) Assume that the specialized legal services relating to nuclear licenses performed by in-house legal counsel of Company P are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 12. Group of services. (i) Company P, Company Q, and Company R are manufacturing companies that sell their products to unrelated retail establishments. Company P has an enterprise resource planning (ERP) system that maintains data relating to accounts payable and accounts receivable information for all three companies. Company P's personnel perform the daily operations on this ERP system such as inputting data relating to accounts payable and accounts receivable into the system and extracting data relating to accounts receivable and accounts payable in the form of reports or electronic media and providing those data to all three companies. Periodically, Company P's computer specialists also modify the ERP system to adapt to changing business functions in all three companies. Company P's computer specialists make these changes by either modifying the underlying software program or by purchasing additional software or hardware from unrelated third party vendors.

(ii) Assume that the services relating to accounts payable and accounts receivable are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these services to Company Q and Company R in accordance with the services cost method.

(iii) Assume that the services performed by Company P's computer specialists that relate to modifying the ERP system are specifically excluded from the services described in a revenue procedure referenced in paragraph (b)(3) of this section as developing hardware or software solutions (such as systems integration, Web site design, writing computer programs, modifying general applications software, or recommending the purchase of commercially available hardware or software). If these services do not constitute low margin covered services within the meaning of paragraph (b)(3)(ii) of this section, then Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 13. Group of services. (i) Company P manufactures and sells widgets under an exclusive contract to Customer 1. Company Q and Company R sell widgets under exclusive contracts to Customer 2 and Customer 3, respectively. At least one year in advance, each of these customers can accurately forecast its need for widgets. Using these forecasts, each customer over the course of the year places orders for widgets with the appropriate company, Company P, Company Q, or Company R. A customer's actual need for widgets seldom deviates from that customer's forecasted need.

(ii) It is most efficient for the PQR Controlled Group companies to manufacture and store an inventory of widgets in advance of delivery. Although all three companies sell widgets, only Company P maintains a centralized warehouse for widgets. Pursuant to a contract, Company P provides storage of these widgets to Company Q and Company R at an arm's length price.

(iii) Company P's personnel also obtain orders from all three companies' customers to draw up purchase orders for widgets as well as make payment to suppliers for widget replacement parts. In addition, Company P's personnel use data entry to input information regarding orders and sales of widgets and replacement parts for all three companies into a centralized computer system. Company P's personnel also maintain the centralized computer system and extract data for all three companies when necessary.

(iv) Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances of the business of the PQR Controlled Group, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b), Company P will be eligible to charge these

services to Company Q and Company R in accordance with the services cost method.

Example 14. Group of services. (i) Company P, Company Q, and Company R assemble and sell gadgets to unrelated customers. Each of these companies purchases the components necessary for assembly of the gadgets from unrelated suppliers. As a service to its subsidiaries, Company P's personnel obtain orders for components from all three companies, prepare purchase orders, and make payment to unrelated suppliers for the components. In addition, Company P's personnel use data entry to input information regarding orders and sales of gadgets for all three companies into a centralized computer. Company P's personnel also maintain the centralized computer system and extract data for all three companies on an as-needed basis. The services provided by Company P personnel, in conjunction with the centralized computer system, constitute a state-of-the-art inventory management system that allows Company P to order components necessary for assembly of the gadgets on a "just-in-time" basis.

(ii) Unrelated suppliers deliver the components directly to Company P, Company Q and Company R. Each company stores the components in its own facilities for use in filling specific customer orders. The companies do not maintain any inventory that is not identified in specific customer orders. Because of the efficiencies associated with services provided by personnel of Company P, all three companies are able to significantly reduce their inventory-related costs. Company P's Chief Executive Officer makes a statement in one of its press conferences with industry analysts that its inventory management system is critical to the company's success.

(iii) Assume that these services relating to tracking purchases and sales of inventory are specified covered services within the meaning of paragraph (b)(3)(i) of this section. Under the facts and circumstances, the taxpayer is unable to reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. Company P is not eligible to charge these services to Company Q and Company R in accordance with the services cost method.

Example 15. Low margin covered services. Company P renders certain accounting services to Company S. Company P uses the services cost method for the accounting services, and determines the amount charged as its total cost of rendering the services, with no markup. Based on an application of the section 482 regulations without regard to this paragraph (b), the interquartile range of arm's length markups on total services costs for these accounting services is between 3%

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and 9%, and the median is 6%. Because the median comparable markup on total services costs is 6%, which is less than 7%, the accounting services constitute low margin covered services within the meaning of paragraph (b)(3)(ii) of this section.

Example 16. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized data processing facility that performs automated invoice processing and order generation for all of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) In evaluating the shares of reasonably anticipated benefits from the centralized data processing services, the total value of the merchandise on the invoices and orders may not provide the most reliable measure of reasonably anticipated benefits shares, because value of merchandise sold does not bear a relationship to the anticipated benefits from the underlying covered services.

(iii) The total volume of orders and invoices processed may provide a more reliable basis for evaluating the shares of reasonably anticipated benefits from the data processing services. Alternatively, depending on the facts and circumstances, total central processing unit time attributable to the transactions of each subsidiary may provide a more reliable basis on which to evaluate the shares of reasonably anticipated benefits.

Example 17. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P operates a centralized center that performs human resources functions, such as administration of pension, retirement, and health insurance plans that are made available to employees of its subsidiaries, Companies X, Y, Z, pursuant to a shared services arrangement.

(ii) In evaluating the shares of reasonably anticipated benefits from these centralized services, the total revenues of each subsidiary may not provide the most reliable measure of reasonably anticipated benefit shares, because total revenues do not bear a relationship to the shares of reasonably anticipated benefits from the underlying services.

(iii) Employee headcount or total compensation paid to employees may provide a more reliable basis for evaluating the shares of reasonably anticipated benefits from the covered services.

Example 18. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P performs human resource services (service A) on behalf of the PXYZ Group that qualify for the services cost method. Under that method, Company P determines the amount charged for these services pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service A

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constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) Companies X, Y and Z reasonably anticipate benefits from service A. Company P does not reasonably anticipate benefits from service A. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of charges pursuant to paragraph (k) of this section to Company X, Y and Z for service A is as follows:

SERVICE A	
[Total cost 300]	
Company	
X	150
Y	75
Z	75

(iii) The total number of employees (employee headcount) in each company is as follows:

Company X—600 employees.
Company Y—250 employees.
Company Z—250 employees.

(iv) Company P allocates the 300 total services costs of service A based on employee headcount as follows:

SERVICE A		
[Total cost 300]		
Allocation key	Company	
	Headcount	Amount
X	600	164
Y	250	68
Z	250	68

(v) Based on these facts, Company P may reasonably conclude that the employee headcount allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to service A.

Example 19. Shared services arrangement and reliable measure of reasonably anticipated benefit (allocation key). (i) Company P performs accounts payable services (service B) on behalf of the PXYZ Group and determines the amount charged for the services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service B is a specified covered service described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs for service B otherwise determined under the services cost method is 500.

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(ii) Companies X, Y and Z reasonably anticipate benefits from service B. Company P does not reasonably anticipate benefits from service B. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of charges pursuant to paragraph (k) of this section to Companies X, Y and Z for service B is as follows:

SERVICE B [Total cost 500]		
Allocation key	Company	
	Transaction Volume	Amount
X	125	
Y	205	
Z	170	

(iii) The total number of employees (employee headcount) in each company is as follows:

Company X—600.

Company Y—200.

Company Z—200.

(iv) The total number of transactions (transaction volume) with uncontrolled customers by each company is as follows:

Company X—2,000.

Company Y—4,000.

Company Z—3,500.

(v) If Company P allocated the 500 total services costs of service B based on employee headcount, the resulting allocation would be as follows:

SERVICE B [Total cost 500]		
Allocation key	Company	
	Headcount	Amount
X	600	300
Y	200	100
Z	200	100

(vi) In contrast, if Company P used volume of transactions with uncontrolled customers as the allocation basis under the shared services arrangement, the allocation would be as follows:

SERVICE B [Total cost 500]		
Allocation key	Company	
	Transaction Volume	Amount
X	2,000	105
Y	4,000	211

SERVICE B—Continued

[Total cost 500]

Allocation key		
	Transaction Volume	Amount
Z	3,500	184

(vii) Based on these facts, Company P may reasonably conclude that the transaction volume, but not the employee headcount, allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to service B.

Example 20. Shared services arrangement and aggregation. (i) Company P performs human resource services (service A) and accounts payable services (service B) on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service A and service B are specified covered services described in a revenue procedure pursuant to paragraph (b)(3)(i) of this section. The total services costs otherwise determined under the services cost method for service A is 300 and for service B is 500; total services costs for services A and B are 800. Company P determines that aggregation of services A and B for purposes of the arrangement is appropriate.

(ii) Companies X, Y and Z reasonably anticipate benefits from services A and B. Company P does not reasonably anticipate benefits from services A and B. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to paragraph (k) of this section to Companies X, Y and Z for services A and B is as follows:

SERVICES A AND B [Total cost 800]		
Allocation key	Company	
	Headcount	Amount
X	350	
Y	100	
Z	350	

(iii) The total volume of transactions with uncontrolled customers in each company is as follows:

Company X—2,000.

Company Y—4,000.

Company Z—4,000.

(iv) The total number of employees in each company is as follows:

Company X—600.

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Company Y—200.
Company Z—200.

(v) If Company P allocated the 800 total services costs of services A and B based on

transaction volume or employee headcount, the resulting allocation would be as follows:

AGGREGATED SERVICES AB

[Total cost 800]

Company	Allocation key		Allocation key	
	Transaction volume	Amount	Headcount	Amount
X	2,000	160	600	480
Y	4,000	320	200	160
Z	4,000	320	200	160

(vi) In contrast, if aggregated services AB were allocated by reference to the total U.S. dollar value of sales to uncontrolled parties (trade sales) by each company, the following results would obtain:

AGGREGATED SERVICES AB

[Total costs 800]

Company	Allocation key	
	Trade sales (millions)	Amount
X	\$400	314
Y	120	94
Z	500	392

(vii) Based on these facts, Company P may reasonably conclude that the trade sales, but not the transaction volume or the employee headcount, allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to services AB.

Example 21. Shared services arrangement and aggregation. (i) Company P performs services A through P on behalf of the PXYZ Group that qualify for the services cost method.

Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. All of these services A through P constitute either specified covered services or low margin covered services described in paragraph (b)(3) of this section. The total services costs for services A through P otherwise determined under the services cost method is 500. Company P determines that aggregation of services A through P for purposes of the arrangement is appropriate.

(ii) Companies X and Y reasonably anticipate benefits from services A through P and Company Z reasonably anticipates benefits from services A through M but not from services N through P (Company Z performs services similar to services N through P on its own behalf). Company P does not reasonably anticipate benefits from services A through P. Assume that if relative reasonably anticipated benefits were precisely known, the appropriate allocation of total charges pursuant to paragraph (k) of this section to Company X, Y, and Z for services A through P is as follows:

Company	Services A–M (cost 490)	Services N–P (cost 10)	Services A–P (total cost 500)
X	90	5	95
Y	240	5	245
Z	160	160	

(iii) The total volume of transactions with uncontrolled customers in each company is as follows:

Company X—2,000.
Company Y—4,500.
Company Z—3,500.

(iv) Company P allocates the 500 total services costs of services A through P based on transaction volume as follows:

AGGREGATED SERVICES A–Z

[Total costs 500]

Company	Allocation key	
	Transaction volume	Amount
X	2,000	100
Y	4,500	225
Z	3,500	175

(v) Based on these facts, Company P may reasonably conclude that the transaction

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volume allocation basis most reliably reflects the participants' respective shares of the reasonably anticipated benefits attributable to services A through P.

Example 22. Renderer reasonably anticipates benefits. (i) Company P renders services on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method. Company P's share of reasonably anticipated benefits from services A, B, C, and D is 20% of the total reasonably anticipated benefits of all participants. Company P's total services cost for services A, B, C, and D charged within the group is 100.

(ii) Based on an application of paragraph (b)(7) of this section, Company P charges 80 which is allocated among Companies X, Y, and Z. No charge is made to Company P under the shared services arrangement for activities that it performs on its own behalf.

Example 23. Coordination with cost sharing arrangement. (i) Company P performs human resource services (service A) on behalf of the PXYZ Group that qualify for the services cost method. Company P determines the amount charged for these services under such method pursuant to a shared services arrangement based on an application of paragraph (b)(7) of this section. Service A constitutes a specified covered service described in a revenue procedure pursuant to paragraph (b)(8)(i) of this section. The total services costs for service A otherwise determined under the services cost method is 300.

(ii) Company X, Y, Z, and P reasonably anticipate benefits from service A. Using a basis of allocation that is consistent with the controlled participants' respective shares of the reasonably anticipated benefits from the shared services, the total charge of 300 is allocated as follows:

X—100.

Y—50.

Z—25.

P—125.

(iii) In addition to performing services, P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000.

(iv) Companies P and X enter into a cost sharing arrangement in accordance with § 1.482-7T. Under the arrangement, Company P will undertake all intangible property development activities. All of Company P's research and development (R&D) activity is devoted to the intangible property development activity under the cost sharing arrangement. Company P will manufacture, market, and otherwise exploit the product in its defined territory. Companies P and X will share intangible property development costs in accordance with their reasonably anticipated benefits from the intangible property, and Company X will make payments to Company P as required under § 1.482-7T. Company

X will manufacture, market, and otherwise exploit the product in the rest of the world.

(v) A portion of the charge under the shared services arrangement is in turn allocable to the intangible property development activity undertaken by Company P. The most reliable estimate of the proportion allocable to the intangible property development activity is determined to be 500 (Company P's R&D expenses) divided by 1,500 (Company P's total non-covered services costs), or one-third. Accordingly, one-third of Company P's charge of 125, or 42, is allocated to the intangible property development activity. Companies P and X must share the intangible property development costs of the cost shared intangible property (including the charge of 42 that is allocated under the shared services arrangement) in proportion to their respective shares of reasonably anticipated benefits under the cost sharing arrangement. That is, the reasonably anticipated benefit shares under the cost sharing arrangement are determined separately from reasonably anticipated benefit shares under the shared services arrangement.

Example 24. Coordination with cost sharing arrangement. (i) The facts and analysis are the same as in *Example 25*, except that Company X also performs intangible property development activities related to the cost sharing arrangement. Using a basis of allocation that is consistent with the controlled participants' respective shares of the reasonably anticipated benefits from the shared services, the 300 of service costs is allocated as follows:

X—100.

Y—50.

Z—25.

P—125.

(ii) In addition to performing services, Company P undertakes 500 of R&D and incurs manufacturing and other costs of 1,000. Company X undertakes 400 of R&D and incurs manufacturing and other costs of 600.

(iii) Companies P and X enter into a cost sharing arrangement in accordance with § 1.482-7T. Under the arrangement, both Companies P and X will undertake intangible property development activities. All of the research and development activity conducted by Companies P and X is devoted to the intangible property development activity under the cost sharing arrangement. Both Companies P and X will manufacture, market, and otherwise exploit the product in their respective territories and will share intangible property development costs in accordance with their reasonably anticipated benefits from the intangible property, and both will make payments as required under § 1.482-7T.

(iv) A portion of the charge under the shared services arrangement is in turn allocable to the intangible property development

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activities undertaken by Companies P and X. The most reliable estimate of the portion allocable to Company P's intangible property development activity is determined to be 500 (Company P's R&D expenses) divided by 1,500 (P's total non-covered services costs), or one-third. Accordingly, one-third of Company P's allocated services cost method charge of 125, or 42, is allocated to its intangible property development activity.

(v) In addition, it is necessary to determine the portion of the charge under the shared services arrangement to Company X that should be further allocated to Company X's intangible property development activities under the cost sharing arrangement. The most reliable estimate of the portion allocable to Company X's intangible property development activity is 400 (Company X's R&D expenses) divided by 1,000 (Company X's costs), or 40%. Accordingly, 40% of the 100 that was allocated to Company X, or 40, is allocated in turn to Company X's intangible property development activities. Company X makes a payment to Company P of 100 under the shared services arrangement and includes 40 of services cost method charges in the pool of intangible property development costs.

(vi) The parties' respective contributions to intangible property development costs under the cost sharing arrangement are as follows:

P: $500 + (0.333 * 125) = 542$

X: $400 + (0.40 * 100) = 440$

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

(2) *Comparability and reliability considerations*—(i) *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). The application of these factors under the comparable uncontrolled services price method is discussed in paragraphs (c)(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 the services rendered, and of the intangible property (if any) used in performing

the services, generally will have the greatest effects 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 services 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 from 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 services 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 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 factors that may be particularly relevant to application of this method include—

- (1) Quality of the services rendered;
- (2) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services, volume, credit and payment terms, allocation of risks, including any contingent-payment terms and whether costs were incurred without a provision for current reimbursement);
- (3) Intangible property (if any) used in rendering the services;

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(4) Geographic market in which the services are rendered or received;

(5) Risks borne (for example, costs incurred to render the services, without provision for current reimbursement);

(6) Duration or quantitative measure of services rendered;

(7) Collateral transactions or ongoing business relationships between the renderer and the recipient, including arrangement for the provision of tangible property in connection with the services; and

(8) Alternatives realistically available to the renderer and the recipient.

(iii) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled services 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 (c) are illustrated by the following examples:

Example 1. Internal comparable uncontrolled services price. Company A, a United States corporation, performs shipping, stevedoring, and related services for controlled and uncontrolled parties on a short-term or as-needed basis. Company A charges uncontrolled parties in Country X a uniform fee of \$60 per container to place loaded cargo containers in Country X on oceangoing vessels for marine transportation. Company A also performs identical services in Country X for its wholly-owned subsidiary, Company B, and there are no substantial differences between the controlled and uncontrolled transactions. In evaluating the appropriate measure of the arm's length price for the container-loading services performed for Company B, because Company A renders substantially identical services in Country X to both controlled and uncontrolled parties, it is determined that the comparable uncontrolled services price constitutes the best method for determining the arm's length price for the controlled services transaction. Based on the reliable data provided by Company A concerning the price charged for services in comparable uncontrolled transactions, a loading charge of \$60 per cargo container will be considered the most reliable measure of the arm's length price for the services rendered to Company B. See paragraph (c)(2)(ii)(A) of this section.

Example 2. External comparable uncontrolled services price. (i) The facts are the same as in

Example 1, except that Company A performs services for Company B, but not for uncontrolled parties. Based on information obtained from unrelated parties (which is determined to be reliable under the comparability standards set forth in paragraph (c)(2) of this section), it is determined that uncontrolled parties in Country X perform services comparable to those rendered by Company A to Company B, and that such parties charge \$60 per cargo container.

(ii) In evaluating the appropriate measure of an arm's length price for the loading services that Company A renders to Company B, the \$60 per cargo container charge is considered evidence of a comparable uncontrolled services price. See paragraph (c)(2)(ii)(A) of this section.

Example 3. External comparable uncontrolled services price. The facts are the same as in *Example 2*, except that uncontrolled parties in Country X render similar loading and stevedoring services, but only under contracts that have a minimum term of one year. If the difference in the duration of the services has 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. Use of valuable intangible property. (i) Company A, a United States corporation in the biotechnology sector, renders research and development services exclusively to its affiliates. Company B is Company A's wholly-owned subsidiary in Country X. Company A renders research and development services to Company B.

(ii) In performing its research and development services function, Company A uses proprietary software that it developed internally. Company A uses the software to evaluate certain genetically engineered compounds developed by Company B. Company A owns the copyright on this software and does not license it to uncontrolled parties.

(iii) No uncontrolled parties can be identified that perform services identical or with a high degree of similarity to those performed by Company A. Because there are material differences for which reliable adjustments cannot be made, the comparable uncontrolled services price method is unlikely to provide a reliable measure of the arm's length price. See paragraph (c)(2)(ii)(A) of this section.

Example 5. Internal comparable. (i) Company A, a United States corporation, and its subsidiaries render computer consulting services relating to systems integration and networking to business clients in various countries. Company A and its subsidiaries render only consulting services, and do not manufacture computer hardware or software nor distribute such products. The controlled

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group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) Company A and its subsidiaries sometimes undertake engagements directly for clients, and sometimes work as subcontractors to unrelated parties on more extensive supply-chain consulting engagements for clients. In undertaking the latter engagements with third party consultants, Company A typically prices its services based on consulting hours worked multiplied by a rate determined for each category of employee. The company also charges, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. The Company has established the following schedule of hourly rates:

Category	Rate
Project managers	\$400 per hour.
Technical staff	\$300 per hour.

(iii) Thus, for example, a project involving 100 hours of the time of project managers and 400 hours of technical staff time would result in the following project fees (without regard to any out-of-pocket expenses): $(100 \text{ hrs.} \times \$400/\text{hr.}) + [400 \text{ hrs.} \times \$300/\text{hr.}] = \$40,000 + \$120,000 = \$160,000$.

(iv) Company B, a Country X subsidiary of Company A, contracts to perform consulting services for a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. In determining an arm's length charge, the price that Company A charges for consulting services as a subcontractor in comparable uncontrolled transactions will be considered evidence of a comparable uncontrolled services price. Thus, in this case, a payment of \$144,000, (or $[75 \text{ hrs.} \times \$400/\text{hr.}] + [380 \text{ hrs.} \times \$300/\text{hr.}] = \$30,000 + \$114,000$) may be used as a measure of the arm's length price for the work performed by Company A project managers and technical staff. In addition, if the comparable uncontrolled services price method is used, then, consistent with the practices employed by the comparables with respect to similar types of expenses, Company B must reimburse Company A for appropriate out-of-pocket expenses. See paragraph (c)(2)(ii)(A) of this section.

Example 6. Adjustments for differences. (i) The facts are the same as in *Example 5*, except that the engagement is undertaken with the client on a fixed fee basis. That is, prior to undertaking the engagement Company B and Company A estimate the resources re-

quired to undertake the engagement, and, based on hourly fee rates, charge the client a single fee for completion of the project. Company A's portion of the engagement results in fees of \$144,000.

(ii) The engagement, once undertaken, requires 20% more hours by each of Companies A and B than originally estimated. Nevertheless, the unrelated client pays the fixed fee that was agreed upon at the start of the engagement. Company B pays Company A \$144,000, in accordance with the fixed fee arrangement.

(iii) Company A often enters into similar fixed fee engagements with clients. In addition, Company A's records for similar engagements show that when it experiences cost overruns, it does not collect additional fees from the client for the difference between projected and actual hours. Accordingly, in evaluating whether the fees paid by Company B to Company A are arm's length, it is determined that no adjustments to the intercompany service charge are warranted. See §1.482-1(d)(3)(ii) and paragraph (c)(2)(ii)(A) of this section.

(5) *Indirect evidence of the price of a comparable uncontrolled services transaction*—(i) *In general.* The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions, but only if—

(A) The data are widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions;

(B) The data are used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions; and

(C) The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent-payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

(ii) *Example.* The following example illustrates this paragraph (c)(5):

Example. Indirect evidence of comparable uncontrolled services price. (i) Company A is a United States insurance company. Company A's wholly-owned Country X subsidiary, Company B, performs specialized risk analysis for Company A as well as for uncontrolled parties. In determining the price actually charged to uncontrolled entities for performing such risk analysis, Company B uses a proprietary, multi-factor computer program, which relies on the gross value of the policies in the customer's portfolio, the relative composition of those policies, their location, and the estimated number of personnel hours necessary to complete the project. Uncontrolled companies that perform comparable risk analysis in the same industry or market-segment use similar proprietary computer programs to price transactions with uncontrolled customers (the competitors' programs may incorporate different inputs, or may assign different weights or values to individual inputs, in arriving at the price).

(ii) During the taxable year subject to audit, Company B performed risk analysis for uncontrolled parties as well as for Company A. Because prices charged to uncontrolled customers reflected the composition of each customer's portfolio together with other factors, the prices charged in Company B's uncontrolled transactions do not provide a reliable basis for determining the comparable uncontrolled services price for the similar services rendered to Company A. However, in evaluating an arm's length price for the studies performed by Company B for Company A, Company B's proprietary computer program may be considered as indirect evidence of the comparable uncontrolled services price that would be charged to perform the services for Company A. The reliability of the results obtained by application of this internal computer program as a measure of an arm's length price for the services will be increased to the extent that Company A used the internal computer program to generate actual transaction prices for risk-analysis studies performed for uncontrolled parties during the same taxable year under audit; Company A used data that are widely and routinely used in the ordinary course of business in the insurance industry to determine the price charged; and Company A reliably adjusted the price charged in the controlled services transaction to reflect differences that may affect the price to which uncontrolled taxpayers would agree.

(d) *Gross services margin method*—(1) *In general.* The gross services margin method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions.

This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs a portion of the services provided.

(2) *Determination of arm's length price*—(i) *In general.* The gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer in the controlled services transaction in connection with the relevant uncontrolled transaction is arm's length by determining the appropriate gross profit of the controlled taxpayer.

(ii) *Relevant uncontrolled transaction.* The relevant uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer as to which the controlled taxpayer performs agent services or an intermediary function.

(iii) *Applicable uncontrolled price.* The applicable uncontrolled price is the price paid or received by the uncontrolled taxpayer in the relevant uncontrolled transaction.

(iv) *Appropriate gross services profit.* The appropriate gross services profit is computed by multiplying the applicable uncontrolled price by the gross services profit margin in comparable uncontrolled transactions. The determination of the appropriate gross services profit will take into account any functions performed by other members of the controlled group, as well as any other relevant factors described in § 1.482-1(d)(3). The comparable gross services profit margin may be determined by reference to the commission in an uncontrolled transaction, where that commission is stated as a percentage of the price charged in the uncontrolled transaction.

(v) *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 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). The application of these factors under the gross services margin method is discussed in paragraphs (d)(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 gross services profit provides compensation for services or functions that bear a relationship to the relevant uncontrolled transaction, including an operating profit in return for the investment of capital and the assumption of risks by the controlled taxpayer performing the services or functions under review. 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 services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit margin should be derived from comparable uncontrolled transactions by the controlled taxpayer under review, because similar characteristics are more likely found among different transactions by the same controlled taxpayer than among transactions by other parties. In the absence of comparable uncontrolled transactions involving the same controlled taxpayer, an appropriate gross services profit margin may be derived from transactions of uncontrolled taxpayers involving comparable services or functions with respect to similarly related transactions.

(B) *Other comparability factors.* Comparability under this method is not dependent on close similarity of the relevant uncontrolled transaction to the

related transactions involved in the uncontrolled comparables. However, substantial differences in the nature of the relevant uncontrolled transaction and the relevant transactions involved in the uncontrolled comparables, such as differences in the type of property transferred or service provided in the relevant uncontrolled transaction, may indicate significant differences in the services or functions performed by the controlled and uncontrolled taxpayers with respect to their respective relevant transactions. Thus, it ordinarily would be expected that the services or functions performed in the controlled and uncontrolled transactions would be with respect to relevant transactions involving the transfer of property within the same product categories or the provision of services of the same general type (for example, information-technology systems design). Furthermore, significant differences in the intangible property (if any) used by the controlled taxpayer in the controlled services transaction as distinct from the uncontrolled comparables may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). 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 services profit margin, adjustments should be made to the gross services profit margin, according to the comparability provisions of § 1.482-1(d)(2). For this purpose, consideration of the total services costs associated with functions performed and risks assumed may be necessary because differences in functions performed are often reflected in these costs. If there

are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related costs. Specific examples of factors that may be particularly relevant to this method include—

(1) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services or function, volume, credit and payment terms, and allocation of risks, including any contingent-payment terms);

(2) Intangible property (if any) used in performing the services or function;

(3) Geographic market in which the services or function are performed or in which the relevant uncontrolled transaction takes place; and

(4) Risks borne, including, if applicable, inventory-type risk.

(D) *Buy-sell distributor.* If a controlled taxpayer that performs an agent service or intermediary function is comparable to a distributor that takes title to goods and resells them, the gross profit margin earned by such distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

(iii) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the gross services margin 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 services profit margin affects the reliability of the results under this method.

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

Example 1. Agent services. Company A and Company B are members of a controlled group. Company A is a foreign manufacturer of industrial equipment. Company B is a U.S. company that acts as a commission agent for Company A by arranging for Company A to make direct sales of the equipment it manufactures to unrelated purchasers in the U.S. market. Company B does not take title to the equipment but instead receives from

Company A commissions that are determined as a specified percentage of the sales price for the equipment that is charged by Company A to the unrelated purchaser. Company B also arranges for direct sales of similar equipment by unrelated foreign manufacturers to unrelated purchasers in the U.S. market. Company B charges these unrelated foreign manufacturers a commission fee of 5% of the sales price charged by the unrelated foreign manufacturers to the unrelated U.S. purchasers for the equipment. Information regarding the comparable agent services provided by Company B to unrelated foreign manufacturers is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjustments for such differences have been made. If the comparable gross services profit margin is 5% of the price charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to 5% of the applicable uncontrolled price charged by Company A in sales of equipment in the relevant uncontrolled transactions.

Example 2. Agent services. The facts are the same as in *Example 1*, except that Company B does not act as a commission agent for unrelated parties and it is not possible to obtain reliable information concerning commission rates charged by uncontrolled commission agents that engage in comparable transactions with respect to relevant sales of property. It is possible, however, to obtain reliable information regarding the gross profit margins earned by unrelated parties that briefly take title to and then resell similar property in uncontrolled transactions, in which they purchase the property from foreign manufacturers and resell the property to purchasers in the U.S. market. Analysis of the facts and circumstances indicates that, aside from certain minor differences for which adjustments can be made, the uncontrolled parties that resell property perform similar functions and assume similar risks as Company B performs and assumes when it acts as a commission agent for Company A's sales of property. Under these circumstances, the gross profit margin earned by the unrelated distributors on the purchase and resale of property may be used, subject to any adjustments for any material differences between the controlled and uncontrolled transactions, as a comparable gross services profit margin. The appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is therefore equal to this comparable gross services margin, multiplied by the applicable uncontrolled price charged by Company A in

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its sales of equipment in the relevant uncontrolled transactions.

Example 3. Agent services. (i) Company A and Company B are members of a controlled group. Company A is a U.S. corporation that renders computer consulting services, including systems integration and networking, to business clients.

(ii) In undertaking engagements with clients, Company A in some cases pays a commission of 3% of its total fees to unrelated parties that assist Company A in obtaining consulting engagements. Typically, such fees are paid to non-computer consulting firms that provide strategic management services for their clients. When Company A obtains a consulting engagement with a client of a non-computer consulting firm, Company A does not subcontract with the other consulting firm, nor does the other consulting firm play any role in Company A's consulting engagement.

(iii) Company B, a Country X subsidiary of Company A, assists Company A in obtaining an engagement to perform computer consulting services for a Company B banking industry client in Country X. Although Company B has an established relationship with its Country X client and was instrumental in arranging for Company A's engagement with the client, Company A's particular expertise was the primary consideration in motivating the client to engage Company A. Based on the relative contributions of Companies A and B in obtaining and undertaking the engagement, Company B's role was primarily to facilitate the consulting engagement between Company A and the Country X client. Information regarding the commissions paid by Company A to unrelated parties for providing similar services to facilitate Company A's consulting engagements is sufficiently complete to conclude that it is likely that all material differences between these uncontrolled transactions and the controlled transaction between Company B and Company A have been identified and that appropriate adjustments have been made for any such differences. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in the relevant transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company A in its relevant uncontrolled consulting engagement with Company B's client.

Example 4. Intermediary function. (i) The facts are the same as in *Example 3*, except that Company B contracts directly with its Country X client to provide computer consulting services and Company A performs the

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consulting services on behalf of Company B. Company A does not enter into a consulting engagement with Company B's Country X client. Instead, Company B charges its Country X client an uncontrolled price for the consulting services, and Company B pays a portion of the uncontrolled price to Company A for performing the consulting services on behalf of Company B.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the consulting contract indicates that Company B functioned primarily as an intermediary contracting party, and the gross services margin method is the most reliable method for determining the amount that Company B may retain as compensation for its intermediary function with respect to Company A's consulting services. In this case, therefore, because Company B entered into the relevant uncontrolled transaction to provide services, Company B receives the applicable uncontrolled price that is paid by the Country X client for the consulting services. Company A technically performs services for Company B when it performs, on behalf of Company B, the consulting services Company B contracted to provide to the Country X client. The arm's length amount that Company A may charge Company B for performing the consulting services on Company B's behalf is equal to the applicable uncontrolled price received by Company B in the relevant uncontrolled transaction, less Company B's appropriate gross services profit, which is the amount that Company B may retain as compensation for performing the intermediary function.

(iii) Reliable data concerning the commissions that Company A paid to unrelated parties for assisting it in obtaining engagements to provide consulting services similar to those it has provided on behalf of Company B provide useful information in applying the gross services margin method. However, consideration should be given to whether the third party commission data may need to be adjusted to account for any additional risk that Company B may have assumed as a result of its function as an intermediary contracting party, compared with the risk it would have assumed if it had provided agent services to assist Company A in entering into an engagement to provide its consulting service directly. In this case, the information regarding the commissions paid by Company A to unrelated parties for providing agent services to facilitate its performance of consulting services for unrelated parties is sufficiently complete to conclude that all material differences between these uncontrolled transactions and the controlled performance of an intermediary function, including possible differences in the amount of risk assumed in connection with performing that function, have been identified and that appropriate adjustments have been made. If

the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in Company B's relevant uncontrolled transactions, then the appropriate gross services profit that Company B may retain as compensation for performing an intermediary function (and the amount, therefore, that is deducted from the applicable uncontrolled price to arrive at the arm's length price that Company A may charge Company B for performing consulting services on Company B's behalf) is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company B in its contract to provide services to the uncontrolled party.

Example 5. External comparable. (i) The facts are the same as in *Example 4*, except that neither Company A nor Company B engages in transactions with third parties that facilitate similar consulting engagements.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the contract indicates that Company B's role was primarily to facilitate the consulting arrangement between Company A and the Country X client. Although no reliable internal data are available regarding comparable transactions with uncontrolled entities, reliable data exist regarding commission rates for similar facilitating services between uncontrolled parties. These data indicate that a 3% commission (3% of total engagement fee) is charged in such transactions. Information regarding the uncontrolled comparables 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 appropriate gross services profit margin is 3% of total fees, then an arm's length result of the controlled services transaction is for Company B to retain an amount equal to 3% of total fees paid to it.

(e) *Cost of services plus method*—(1) *In general.* The cost of services plus method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit markup realized in comparable uncontrolled transactions. The cost of services plus method is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties. This method is ordinarily not used in cases where the controlled services transaction involves a contingent-payment arrangement, as described in paragraph (i)(2) of this section.

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

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

(iii) *Comparable transactional costs.* Comparable transactional costs consist of the costs of providing the services under review that are taken into account as the basis for determining the gross services profit markup in comparable uncontrolled transactions. Depending on the facts and circumstances, such costs typically include all compensation attributable to employees directly involved in the performance of such services, materials and supplies consumed or made available in rendering such services, and may include as well other costs of rendering the services. Comparable transactional costs must be determined on a basis that will facilitate comparison with the comparable uncontrolled transactions. For that reason, comparable transactional costs may not necessarily equal total services costs, as defined in paragraph (j) of this section, and in appropriate cases may be a subset of total services costs. Generally accepted accounting principles or Federal income tax accounting rules (where Federal income tax data for comparable transactions or business activities are available) may provide useful guidance but will not conclusively establish the appropriate comparable transactional costs for purposes of this method.

(iv) *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

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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 service renderer's gross services profit provides compensation for performing services related to the controlled services transaction under review, including an operating profit for the service renderer's investment of capital and assumptions 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 services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit markup should be derived from comparable uncontrolled transactions of the same taxpayer participating in the controlled services transaction because similar characteristics are more likely to be found among services provided by the same service provider than among services provided by other service providers. In the absence of such services transactions, an appropriate gross services profit markup may be derived from comparable uncontrolled services transactions of other service providers. If the appropriate gross services profit markup is derived from comparable uncontrolled services transactions of other service providers, in evaluating comparability the controlled taxpayer must consider the results under this method expressed as a markup on total services costs of the controlled taxpayer, because differences in functions performed may be reflected in differences in service costs other than those included in comparable transactional costs.

(B) *Other comparability factors*. Comparability under this method is less dependent on close similarity between the services provided than under the comparable uncontrolled services price method. Substantial differences in the services may, however, indicate signifi-

cant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve services of the same general type (for example, information-technology systems design). Furthermore, if a significant amount of the controlled taxpayer's comparable transactional costs consists of service costs incurred in a tax accounting period other than the tax accounting period under review, the reliability of the analysis would be reduced. In addition, significant differences in the value of the services rendered, due for example to the use of valuable intangible property, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency-related factors (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). 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 the controlled and uncontrolled transactions*. If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit markup, adjustments should be made to the gross services profit markup earned in the comparable uncontrolled transaction according to the provisions of § 1.482-1(d)(2). For this purpose, consideration of the comparable transactional costs associated with the functions performed and risks assumed may be necessary, because differences in the functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related comparable transactional costs. Specific examples of the factors that may be particularly relevant to this method include—

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- (1) The complexity of the services;
- (2) The duration or quantitative measure of services;
- (3) Contractual terms (for example, scope and terms of warranties or guarantees provided, volume, credit and payment terms, allocation of risks, including any contingent-payment terms);
- (4) Economic circumstances; and
- (5) Risks borne.

(iii) *Data and assumptions*—(A) *In general*. The reliability of the results derived from the cost of services 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 services profit markup affects the reliability of the results under this method. Thus, for example, if differences in cost accounting practices would materially affect the gross services profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results obtained under this method. Further, reliability under this method depends on the extent to which the controlled and uncontrolled transactions reflect consistent reporting of comparable transactional costs. For purposes of this paragraph (e)(3)(iii)(B), the term *comparable transactional costs* includes the cost of acquiring tangible property that is transferred (or used) with the services, to the extent that the arm's length price of the tangible property is not separately evaluated as a controlled transaction under another provision.

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

Example 1. Internal comparable. (i) Company A designs and assembles information-technology networks and systems. When Company A renders services for uncontrolled parties, it receives compensation based on time and materials as well as certain other related costs necessary to complete the project. This fee includes the cost of hardware and software purchased from uncontrolled vendors and incorporated in the final

network or system, plus a reasonable allocation of certain specified overhead costs incurred by Company A in providing these services. Reliable accounting records maintained by Company A indicate that Company A earned a gross services profit markup of 10% on its time, materials and specified overhead in providing design services during the year under examination on information technology projects for uncontrolled entities.

(ii) Company A designed an information-technology network for its Country X subsidiary, Company B. The services rendered to Company B are similar in scope and complexity to services that Company A rendered to uncontrolled parties during the year under examination. Using Company A's accounting records (which are determined to be reliable under paragraph (e)(3) of this section), it is possible to identify the comparable transactional costs involved in the controlled services transaction with reference to the costs incurred by Company A in rendering similar design services to uncontrolled parties. Company A's records indicate that it does not incur any additional types of costs in rendering similar services to uncontrolled customers. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on the gross services profit markup data derived from Company A's uncontrolled transactions involving similar design services, an arm's length result for the controlled services transaction is equal to the price that will allow Company A to earn a 10% gross services profit markup on its comparable transactional costs.

Example 2. Inability to adjust for differences in comparable transactional costs. The facts are the same as in *Example 1*, except that Company A's staff that rendered the services to Company B consisted primarily of engineers in training status or on temporary rotation from other Company A subsidiaries. In addition, the Company B network incorporated innovative features, including specially designed software suited to Company B's requirements. The use of less-experienced personnel and staff on temporary rotation, together with the special features of the Company B network, significantly increased the time and costs associated with the project as compared to time and costs associated with similar projects completed for uncontrolled customers. These factors constitute material differences between the controlled and the uncontrolled transactions that affect the determination of Company A's comparable transactional costs associated with the controlled services transaction, as well as the gross services profit

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markup. Moreover, it is not possible to perform reliable adjustments for these differences on the basis of the available accounting data. Under these circumstances, the reliability of the cost of services plus method as a measure of an arm's length price is substantially reduced.

Example 3. Operating loss by reference to total services costs. The facts and analysis are the same as in *Example 1*, except that an unrelated Company C, instead of Company A, renders similar services to uncontrolled parties and publicly available information indicates that Company C earned a gross services profit markup of 10% on its time, materials and certain specified overhead in providing those services. As in *Example 1*, Company A still provides services for its Country X subsidiary, Company B. In accordance with the requirements in paragraph (e)(3)(ii) of this section, the taxpayer performs additional analysis and restates the results of Company A's controlled services transaction with its Country X subsidiary, Company B, in the form of a markup on Company A's total services costs. This analysis by reference to total services costs shows that Company A generated an operating loss on the controlled services transaction, which indicates that functional differences likely exist between the controlled services transaction performed by Company A and uncontrolled services transactions performed by Company C, and that these differences may not be reflected in the comparable transactional costs. Upon further scrutiny, the presence of such functional differences between the controlled and uncontrolled transactions may indicate that the cost of services plus method does not provide the most reliable measure of an arm's length result under the facts and circumstances.

Example 4. Internal comparable. (i) Company A, a U.S. corporation, and its subsidiaries perform computer consulting services relating to systems integration and networking for business clients in various countries. Company A and its subsidiaries render only consulting services and do not manufacture or distribute computer hardware or software to clients. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) On some occasions, Company A and its subsidiaries undertake engagements directly for clients. On other occasions, they work as subcontractors for uncontrolled parties on more extensive consulting engagements for clients. In undertaking the latter engagements with third-party consultants, Company A typically prices its services at four times the compensation costs of its consult-

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ants, defined as the consultants' base salary plus estimated fringe benefits, as defined in this table:

Category	Rate
Project managers	\$100 per hour.
Technical staff	\$75 per hour.

(iii) In uncontrolled transactions, Company A also charges the customer, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. Thus, for example, a project involving 100 hours of time from project managers, and 400 hours of technical staff time would result in total compensation costs to Company A of $(100 \text{ hrs.} \times \$100/\text{hr.}) + (400 \text{ hrs.} \times \$75/\text{hr.}) = \$10,000 + \$30,000 = \$40,000$. Applying the markup of 300%, the total fee charged would thus be $(4 \times \$40,000)$, or \$160,000, plus out-of-pocket expenses.

(iv) Company B, a Country X subsidiary of Company A, contracts to render consulting services to a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses the services of Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on reliable data concerning the compensation costs to Company A, an arm's length result for the controlled services transaction is equal to \$144,000. This is calculated as follows: $[4 \times (75 \text{ hrs.} \times \$100/\text{hr.})] + [4 \times (380 \text{ hrs.} \times \$75/\text{hr.})] = \$30,000 + \$114,000 = \$144,000$, reflecting a 300% markup on the total compensation costs for Company A project managers and technical staff. In addition, consistent with Company A's pricing of uncontrolled transactions, Company B must reimburse Company A for appropriate out-of-pocket expenses incurred in performing the services.

(f) *Comparable profits method*—(1) *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. The rules in § 1.482-5 relating to the comparable profits method apply to controlled services transactions, except as modified in this paragraph (f).

(2) *Determination of arm's length result*—(i) *Tested party.* This paragraph (f)

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applies where the relevant business activity of the tested party as determined under §1.482-5(b)(2) is the rendering of services in a controlled services transaction. Where the tested party determined under §1.482-5(b)(2) is instead the recipient of the controlled services, the rules under this paragraph (f) are not applicable to determine the arm's length result.

(ii) *Profit level indicators.* In addition to the profit level indicators provided in §1.482-5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs (as defined in paragraph (j) of this section).

(iii) *Comparability and reliability considerations—Data and assumptions—Consistency in accounting.* Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method. Adjustments may be appropriate if materially different treatment is applied to particular cost items related to the relevant business activity of the tested party and the uncontrolled service providers. For example, adjustments may be appropriate where the tested party and the uncontrolled comparables use inconsistent approaches to classify similar expenses as "cost of goods sold" and "selling, general, and administrative expenses." Although distinguishing between these two categories may be difficult, the distinction is less important to the extent that the ratio of operating profit to total services costs is used as the appropriate profit level indicator. Determining whether adjustments are necessary under these or similar circumstances requires thorough analysis of the functions performed and consideration of the cost accounting practices of the tested party and the uncontrolled comparables. Other adjustments as provided in §1.482-5(c)(2)(iv) may also be necessary to increase the reliability of the results under this method.

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

Example 1. Ratio of operating profit to total services costs as the appropriate profit level indicator. (i) A Country T parent firm, Company A, and its Country Y subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain advertising services for itself and its affiliates. In year 1, Company A renders advertising services to Company B.

(ii) Based on the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company A is selected as the tested party. No data are available for comparable independent manufacturing firms that render advertising services to third parties. Financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity in Country X. The ten firms are determined to be comparable under §1.482-5(c). Neither Company A nor the comparable companies use valuable intangible property in rendering the services.

(iii) Based on the available financial data of the comparable companies, it cannot be determined whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies.

Example 2. Application of the operating profit to total services costs profit level indicator. (i) Company A is a foreign subsidiary of Company B, a U.S. corporation. Company B is under examination for its year 1 taxable year. Company B renders management consulting services to Company A. Company B's consulting function includes analyzing Company A's operations, benchmarking Company A's financial performance against companies in the same industry, and to the extent necessary, developing a strategy to improve Company A's operational performance. The accounting records of Company B allow reliable identification of the total services costs of the consulting staff associated with the management consulting services rendered to

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Company A. Company A reimburses Company B for its costs associated with rendering the consulting services, with no markup.

(ii) Based on all the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company B is selected as the tested party, and its rendering of management consulting services is identified as the relevant business activity. Data are available from ten domestic companies that operate in the industry segment involving management consulting and that perform activities comparable to the relevant business activity of Company B. These comparables include entities that primarily perform management consulting services for uncontrolled parties. The comparables incur similar risks as Company

B incurs in performing the consulting services and do not make use of valuable intangible property or special processes.

(iii) Based on the available financial data of the comparables, it cannot be determined whether the comparables report their costs for financial accounting purposes in the same manner as Company B reports its costs in the relevant business activity. The available financial data for the comparables report only an aggregate figure for costs of goods sold and operating expenses, and do not segment the underlying services costs. Due to this limitation, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator.

(iv) For the taxable years 1 through 3, Company B shows the following results for the services performed for Company A:

	Year 1	Year 2	Year 3	Average
Revenues	1,200,000	1,100,000	1,300,000	1,200,000
Cost of Goods Sold	100,000	100,000	N/A	66,667
Operating Expenses	1,100,000	1,000,000	1,300,000	1,133,333
Operating Profit	0	0	0	0

(v) After adjustments have been made to account for identified material differences between the relevant business activity of Company B and the comparables, the average ratio for the taxable years 1 through 3 of operating profit to total services costs is calculated for each of the uncontrolled service providers. Applying each ratio to Company B's average total services costs from the relevant business activity for the taxable years 1 through 3 would lead to the following comparable operating profit (COP) for the services rendered by Company B:

Uncontrolled service provider	OP/Total service costs (percent)	Company B COP
Company 1	15.75	\$189,000
Company 2	15.00	180,000
Company 3	14.00	168,000
Company 4	13.30	159,600
Company 5	12.00	144,000
Company 6	11.30	135,600
Company 7	11.25	135,000
Company 8	11.18	134,160
Company 9	11.11	133,320
Company 10	10.75	129,000

(vi) The available data are not sufficiently complete to conclude that it is likely that all material differences between the relevant business activity of Company B and the comparables have been identified. Therefore, an arm's length range can be established only pursuant to § 1.482-1(e)(2)(iii)(B). The arm's length range is established by reference to the interquartile range of the results as calculated under § 1.482-1(e)(2)(iii)(C), which consists of the results ranging from

\$168,000 to \$134,160. Company B's reported average operating profit of zero (\$0) falls outside this range. Therefore, an allocation may be appropriate.

(vii) Because Company B reported income of zero, to determine the amount, if any, of the allocation, Company B's reported operating profit for year 3 is compared to the comparable operating profits derived from the comparables' results for year 3. The ratio of operating profit to total services costs in year 3 is calculated for each of the comparables and applied to Company B's year 3 total services costs to derive the following results:

Uncontrolled service provider	OP/Total service costs (for year 3) (percent)	Company B COP
Company 1	15.00	\$195,000
Company 2	14.75	191,750
Company 3	14.00	182,000
Company 4	13.50	175,500
Company 5	12.30	159,900
Company 6	11.05	143,650
Company 7	11.03	143,390
Company 8	11.00	143,000
Company 9	10.50	136,500
Company 10	10.25	133,250

(viii) Based on these results, the median of the comparable operating profits for year 3 is \$151,775. Therefore, Company B's income for year 3 is increased by \$151,775, the difference between Company B's reported operating profit for year 3 of zero and the median of the comparable operating profits for year 3.

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Example 3. Material difference in accounting for stock-based compensation. (i) Taxpayer, a U.S. corporation the stock of which is publicly traded, performs controlled services for its wholly-owned subsidiaries. The arm's length price of these controlled services is evaluated under the comparable profits method for services in paragraph (f) of this section by reference to the net cost plus profit level indicator (PLI). Taxpayer is the tested party under paragraph (f)(2)(i) of this section. The Commissioner identifies the most narrowly identifiable business activity of the tested party for which data are available that incorporate the controlled transaction (the relevant business activity). The Commissioner also identifies four uncontrolled domestic service providers, Companies A, B, C, and D, each of which performs exclusively activities similar to the relevant business activity of Taxpayer that is subject to analysis under paragraph (f) of this section. The stock of Companies A, B, C, and D is publicly traded on a U.S. stock exchange. Assume that Taxpayer makes an election to apply these regulations to earlier taxable years.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as de-

termined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees' performance of the relevant business activity is 500 for the taxable year in question. In evaluating the controlled services, Taxpayer includes salaries, fringe benefits, and related compensation of these employees in "total services costs," as defined in paragraph (j) of this section. Taxpayer does not include any amount attributable to stock options in total services costs, nor does it deduct that amount in determining "reported operating profit" within the meaning of §1.482-5(d)(5), for the year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Under a fair value method in accordance with U.S. generally accepted accounting principles, the comparables include in total compensation the value of the stock options attributable to the employees' performance of the relevant business activity for the annual financial reporting period, and treat this amount as an expense in determining operating profit for financial accounting purposes. The treatment of employee stock options is summarized in the following table:

	Salaries and other non-operation compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	500	0
Company A	7,000	2,000	2,000
Company B	4,300	250	250
Company C	12,000	4,500	4,500
Company D	15,000	2,000	2,000

(iv) A material difference in accounting for stock-based compensation (within the meaning of §1.482-7T(d)(3)(i)) exists. Analysis indicates that this difference would materially affect the measure of an arm's length result under this paragraph (f). In making an adjustment to improve comparability under §§1.482-1(d)(2) and 1.482-5(c)(2)(iv), the Commissioner includes in total services costs of the tested party the total compensation costs of 1,500 (including stock option fair value). In addition, the Commissioner calculates the net cost plus PLI by reference to the financial-accounting data of Companies A, B, C, and D, which take into account compensatory stock options.

Example 4. Material difference in utilization of stock-based compensation. (i) The facts are the same as in paragraph (i) of *Example 3*.

(ii) No stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Thus, no deduction for stock options is made in determining "reported operating profit" (within the meaning of §1.482-5(d)(5)) for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table:

	Salaries and other non-operation compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	0	N/A

	Salaries and other non-operation compensation	Stock options fair value	Stock options expensed
Company A	7,000	2,000	0
Company B	4,300	250	0
Company C	12,000	4,500	0
Company D	15,000	2,000	0

(iv) A material difference in the utilization of stock-based compensation (within the meaning of §1.482-7T(d)(3)(i)) exists. Analysis indicates that these differences would materially affect the measure of an arm's length result under this paragraph (f). In evaluating the comparable operating profits of the tested party, the Commissioner uses Taxpayer's total services costs, which include total compensation costs of 1,000. In considering whether an adjustment is necessary to improve comparability under §§1.482-1(d)(2) and 1.482-5(c)(2)(iv), the Commissioner recognizes that the total compensation provided to employees of Taxpayer is comparable to the total compensation provided to employees of

Companies A, B, C, and D. Because Companies A, B, C, and D do not expense stock-based compensation for financial accounting purposes, their reported operating profits must be adjusted in order to improve comparability with the tested party. The Commissioner increases each comparable's total services costs, and also reduces its reported operating profit, by the fair value of the stock-based compensation incurred by the comparable company.

(v) The adjustments to the data of Companies A, B, C, and D described in paragraph (iv) of this *Example 4* are summarized in the following table:

	Salaries and other non-operation compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (Percent)
Per financial statements:					
Company A	7,000	2,000	25,000	6,000	24.00
Company B	4,300	250	12,500	2,500	20.00
Company C	12,000	4,500	36,000	11,000	30.56
Company D	15,000	2,000	27,000	7,000	25.93
As adjusted:					
Company A	7,000	2,000	27,000	4,000	14.81
Company B	4,300	250	12,750	2,250	17.65
Company C	12,000	4,500	40,500	6,500	16.05
Company D	15,000	2,000	29,000	5,000	17.24

Example 5. Non-material difference in utilization of stock-based compensation. (i) The facts are the same as in paragraph (i) of *Example 3*.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to the employees' performance of the relevant business activity is 50 for the taxable year. Taxpayer includes salaries, fringe benefits, and all other compensation of these employees (including the stock option fair value) in "total services costs," as defined in paragraph (j) of this section, and

deducts these amounts in determining "reported operating profit" within the meaning of §1.482-5(d)(5), for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D, but none of these companies expense stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies A, B, C, and D disclose the fair value of the stock options for financial accounting purposes. The utilization and treatment of employee stock options is summarized in the following table:

	Salaries and other non-operation compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	50	50
Company A	7,000	100	0
Company B	4,300	40	0

	Salaries and other non-operation compensation	Stock options fair value	Stock options expensed
Company C	12,000	130	0
Company D	15,000	75	0

(iv) Analysis of the data reported by Companies A, B, C, and D indicates that an adjustment for differences in utilization of

stock-based compensation would not have a material effect on the determination of an arm's length result.

	Salaries and other non-operation compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (percent)
Per financial statements:					
Company A	7,000	100	25,000	6,000	24.00
Company B	4,300	40	12,500	2,500	20.00
Company C	12,000	130	36,000	11,000	30.56
Company D	15,000	75	27,000	7,000	25.93
As adjusted:					
Company A	7,000	100	25,100	5,900	23.51
Company B	4,300	40	12,540	2,460	19.62
Company C	12,000	130	36,130	10,870	30.09
Company D	15,000	75	27,075	6,925	25.58

(v) Under the circumstances, the difference in utilization of stock-based compensation would not materially affect the determination of the arm's length result under this paragraph (f). Accordingly, in calculating the net cost plus PLI, no comparability adjustment is made to the data of Companies A, B, C, or D pursuant to §§1.482-1(d)(2) and 1.482-5(c)(2)(iv).

Example 6. Material difference in comparables' accounting for stock-based compensation. (i) The facts are the same as in paragraph (i) of *Example 3*.

(ii) Stock options are granted to the employees of Taxpayer that engage in the relevant business activity. Assume that, as determined under a method in accordance with U.S. generally accepted accounting principles, the fair value of such stock options attributable to employees' performance of the relevant business activity is 500 for the taxable year. Taxpayer includes salaries,

fringe benefits, and all other compensation of these employees (including the stock option fair value) in "total services costs," as defined in paragraph (j) of this section, and deducts these amounts in determining "reported operating profit" (within the meaning of §1.482-5(d)(5)) for the taxable year under examination.

(iii) Stock options are granted to the employees of Companies A, B, C, and D. Companies A and B expense the stock options for financial accounting purposes in accordance with U.S. generally accepted accounting principles. Companies C and D do not expense the stock options for financial accounting purposes. Under a method in accordance with U.S. generally accepted accounting principles, however, Companies C and D disclose the fair value of these options in their financial statements. The utilization and accounting treatment of options are depicted in the following table:

	Salary and other non-operation compensation	Stock options fair value	Stock options expensed
Taxpayer	1,000	500	500
Company A	7,000	2,000	2,000
Company B	4,300	250	250
Company C	12,000	4,500	0
Company D	15,000	2,000	0

(iv) A material difference in accounting for stock-based compensation (within the meaning of §1.482-7T(d)(3)(i)) exists. Analysis indicates that this difference would materially

affect the measure of the arm's length result under paragraph (f) of this section. In evaluating the comparable operating profits of the tested party, the Commissioner includes in

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total services costs Taxpayer's total compensation costs of 1,500 (including stock option fair value of 500). In considering whether an adjustment is necessary to improve comparability under §§ 1.482-1(d)(2) and 1.482-5(c)(2)(iv), the Commissioner recognizes that the total employee compensation (including stock options provided by Taxpayer and Companies A, B, C, and D) provides a reliable basis for comparison. Because Companies A and B expense stock-based compensation for financial accounting purposes, whereas Companies C and D do not, an adjustment to the comparables' operating profit is necessary.

In computing the net cost plus PLI, the Commissioner uses the financial-accounting data of Companies A and B, as reported. The Commissioner increases the total services costs of Companies C and D by amounts equal to the fair value of their respective stock options, and reduces the operating profits of Companies C and D accordingly.

(v) The adjustments described in paragraph (iv) of this *Example 6* are depicted in the following table. For purposes of illustration, the unadjusted data of Companies A and B are also included.

	Salaries and other non-option compensation	Stock options fair value	Total services costs (A)	Operating profit (B)	Net cost plus PLI (B/A) (percent)
Per financial statements:					
Company A	7,000	2,000	27,000	4,000	14.80
Company B	4,300	250	12,750	2,250	17.65
As adjusted:					
Company C	12,000	4,500	40,500	6,500	16.05
Company D	15,000	2,000	29,000	5,000	17.24

(g) *Profit split method*—(1) *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 relative value of each controlled taxpayer's contribution is determined in a manner that reflects the functions performed, risks assumed and resources employed by such controlled taxpayer in the relevant business activity. For application of the profit split method (both the comparable profit split and the residual profit split), see § 1.482-6. The residual profit split method may not be used where only one controlled taxpayer makes significant nonroutine contributions.

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

Example 1. Residual profit split. (i) Company A, a corporation resident in Country X, auctions spare parts by means of an interactive database. Company A maintains a database that lists all spare parts available for auction. Company A developed the software used to run the database. Company A's database is managed by Company A employees in a data center located in Country X, where storage and manipulation of data also take place. Company A has a wholly-owned sub-

sidiary, Company B, located in Country Y. Company B performs marketing and advertising activities to promote Company A's interactive database. Company B solicits unrelated companies to auction spare parts on Company A's database, and solicits customers interested in purchasing spare parts online. Company B owns and maintains a computer server in Country Y, where it receives information on spare parts available for auction. Company B has also designed a specialized communications network that connects its data center to Company A's data center in Country X. The communications network allows Company B to enter data from uncontrolled companies on Company A's database located in Country X. Company B's communications network also allows uncontrolled companies to access Company A's interactive database and purchase spare parts. Company B bore the risks and cost of developing this specialized communications network. Company B enters into contracts with uncontrolled companies and provides the companies access to Company A's database through the Company B network.

(ii) Analysis of the facts and circumstances indicates that both Company A and Company B possess valuable intangible property that they use to conduct the spare parts auction business. Company A bore the economic risks of developing and maintaining software and the interactive database. Company B bore the economic risks of developing the necessary technology to transmit information from its server to Company A's data center, and to allow uncontrolled companies to access Company A's database. Company B helped to enhance the value of Company A's

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trademark and to establish a network of customers in Country Y. In addition, there are no market comparables for the transactions between Company A and Company B to reliably evaluate them separately. Given the facts and circumstances, the Commissioner determines that a residual profit split method will provide the most reliable measure of an arm's length result.

(iii) Under the residual profit split method, profits are first allocated based on the routine contributions of each taxpayer. Routine contributions include general sales, marketing or administrative functions performed by Company B for Company A for which it is possible to identify market returns. Any residual profits will be allocated based on the nonroutine contributions of each taxpayer. Since both Company A and Company B provided nonroutine contributions, the residual profits are allocated based on these contributions.

Example 2. Residual profit split. (i) Company A, a Country 1 corporation, provides specialized services pertaining to the processing and storage of Level 1 hazardous waste (for purposes of this example, the most dangerous type of waste). Under long-term contracts with private companies and governmental entities in Country 1, Company A performs multiple services, including transportation of Level 1 waste, development of handling and storage protocols, record-keeping, and supervision of waste-storage facilities owned and maintained by the contracting parties. Company A's research and development unit has also developed new and unique processes for transport and storage of Level 1 waste that minimize environmental and occupational effects. In addition to this novel technology, Company A has substantial know-how and a long-term record of safe operations in Country 1.

(ii) Company A's subsidiary, Company B, has been in operation continuously for a number of years in Country 2. Company B has successfully completed several projects in Country 2 involving Level 2 and Level 3 waste, including projects with government-owned entities. Company B has a license in Country 2 to handle Level 2 waste (Level 3 does not require a license). Company B has established a reputation for completing these projects in a responsible manner. Company B has cultivated contacts with procurement officers, regulatory and licensing officials, and other government personnel in Country 2.

(iii) Country 2 government publishes invitations to bid on a project to handle the country's burgeoning volume of Level 1 waste, all of which is generated in government-owned facilities. Bidding is limited to companies that are domiciled in Country 2 and that possess a license from the government to handle Level 1 or Level 2 waste. In an effort to submit a winning bid to secure

the contract, In an effort to submit a winning bid to secure the contract, Company B points to its Level 2 license and its record of successful completion of projects, and also demonstrates to Country 2 government that it has access to substantial technical expertise pertaining to processing of Level 1 waste.

(iv) Company A enters into a long-term technical services agreement with Company B. Under this agreement, Company A agrees to supply to Company B project managers and other technical staff who have detailed knowledge of Company A's proprietary Level 1 remediation techniques. Company A commits to perform under any long-term contracts entered into by Company B. Company B agrees to compensate Company A based on a markup on Company A's marginal costs (pro rata compensation and current expenses of Company A personnel). In the bid on the Country 2 contract for Level 1 waste remediation, Company B proposes to use a multidisciplinary team of specialists from Company A and Company B. Project managers from Company A will direct the team, which will also include employees of Company B and will make use of physical assets and facilities owned by Company B. Only Company A and Company B personnel will perform services under the contract. Country 2 grants Company B a license to handle Level 1 waste.

(v) Country 2 grants Company B a five-year, exclusive contract to provide processing services for all Level 1 hazardous waste generated in County 2. Under the contract, Company B is to be paid a fixed price per ton of Level 1 waste that it processes each year. Company B undertakes that all services provided will meet international standards applicable to processing of Level 1 waste. Company B begins performance under the contract.

(vi) Analysis of the facts and circumstances indicates that both Company A and Company B make nonroutine contributions to the Level 1 waste processing activity in Country 2. In addition, it is determined that reliable comparables are not available for the services that Company A provides under the long-term contract, in part because those services incorporate specialized knowledge and process intangible property developed by Company A. It is also determined that reliable comparables are not available for the Level 2 license in Country 2, the successful track record, the government contacts with Country 2 officials, and other intangible property that Company B provided. In view of these facts, the Commissioner determines that the residual profit split method for services in paragraph (g) of this section provides the most reliable means of evaluating the arm's length results for the transaction. In evaluating the appropriate returns to Company A and Company B

for their respective contributions, the Commissioner takes into account that the controlled parties incur different risks, because the contract between the controlled parties provides that Company A will be compensated on the basis of marginal costs incurred, plus a markup, whereas the contract between Company B and the government of Country 2 provides that Company B will be compensated on a fixed-price basis per ton of Level 1 waste processed.

(vii) In the first stage of the residual profit split, an arm's length return is determined for routine activities performed by Company B in Country 2, such as transportation, recordkeeping, and administration. In addition, an arm's length return is determined for routine activities performed by Company A (administrative, human resources, *etc.*) in connection with providing personnel to Company B. After the arm's length return for these functions is determined, residual profits may be present. In the second stage of the residual profit split, any residual profit is allocated by reference to the relative value of the nonroutine contributions made by each taxpayer. Company A's nonroutine contributions include its commitment to perform under the contract and the specialized technical knowledge made available through the project managers under the services agreement with Company B. Company B's nonroutine contributions include its licenses to handle Level 1 and Level 2 waste in Country 2, its knowledge of and contacts with procurement, regulatory and licensing officials in the government of Country 2, and its record in Country 2 of successfully handling non-Level 1 waste.

(h) *Unspecified methods.* Methods not specified in paragraphs (b) through (g) of this section may be used to evaluate whether the amount charged in a controlled services transaction is arm's length. Any method used under this paragraph (h) 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, including economically similar transactions structured as other than services transactions, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled services price method compares a controlled services 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 services transaction. Therefore, in establishing whether a controlled services 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 services transaction (for example, outsourcing a particular service function, rather than performing the function itself). 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 an unspecified 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.

Example. (i) Company T, a U.S. corporation, develops computer software programs including a real estate investment program that performs financial analysis of commercial real properties. Companies U, V, and W are owned by Company T. The primary business activity of Companies U, V, and W is commercial real estate development. For business reasons, Company T does not sell the computer program to its customers (on a compact disk or via download from Company T's server through the Internet). Instead, Company T maintains the software program on its own server and allows customers to access the program through the Internet by using a password. The transactions between Company T and Companies U, V, and W are structured as controlled services transactions whereby Companies U, V, and W obtain access via the Internet to Company T's software program for financial analysis. Each year, Company T provides a revised version of the computer program including the most recent data on the commercial real estate market, rendering the old version obsolete.

(ii) In evaluating whether the consideration paid by Companies U, V, and W to Company T was arm's length, the Commissioner may consider, subject to the best method rule of § 1.482-1(c), Company T's alternative of selling the computer program to Companies U, V, and W on a compact disk or

via download through the Internet. The Commissioner determines that the controlled services transactions between Company T and Companies U, V, and W are comparable to the transfer of a similar software program on a compact disk or via download through the Internet between uncontrolled parties. Subject to adjustments being made for material differences between the controlled services transactions and the comparable uncontrolled transactions, the uncontrolled transfers of tangible property may be used to evaluate the arm's length results for the controlled services transactions between Company T and Companies U, V, and W.

(i) *Contingent-payment contractual terms for services*—(1) *Contingent-payment contractual terms recognized in general*. In the case of a contingent-payment arrangement, the arm's length result for the controlled services transaction generally would not require payment by the recipient to the renderer in the tax accounting period in which the service is rendered if the specified contingency does not occur in that period. If the specified contingency occurs in a tax accounting period subsequent to the period in which the service is rendered, the arm's length result for the controlled services transaction generally would require payment by the recipient to the renderer on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer in performing the activities in the absence of a provision that unconditionally obligates the recipient to pay for the activities performed in the tax accounting period in which the service is rendered.

(2) *Contingent-payment arrangement*. For purposes of this paragraph (i), an arrangement will be treated as a contingent-payment arrangement if it meets all of the requirements in paragraph (i)(2)(i) of this section and is consistent with the economic substance and conduct requirement in paragraph (i)(2)(ii) of this section.

(i) *General requirements*—(A) *Written contract*. The arrangement is set forth in a written contract entered into prior to, or contemporaneous with, the start of the activity or group of activities constituting the controlled services transaction.

(B) *Specified contingency*. The contract states that payment for a con-

trolled services transaction is contingent (in whole or in part) upon the happening of a future benefit (within the meaning of § 1.482-9(1)(3)) for the recipient directly related to the activity or group of activities. For purposes of the preceding sentence, whether the future benefit is directly related to the activity or group of activities is evaluated based on all the facts and circumstances.

(C) *Basis for payment*. The contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer.

(ii) *Economic substance and conduct*. The arrangement, including the contingency and the basis for payment, is consistent with the economic substance of the controlled transaction and the conduct of the controlled parties. See § 1.482-1(d)(3)(ii)(B).

(3) *Commissioner's authority to impute contingent-payment terms*. Consistent with the authority in § 1.482-1(d)(3)(ii)(B), the Commissioner may impute contingent-payment contractual terms in a controlled services transaction if the economic substance of the transaction is consistent with the existence of such terms.

(4) *Evaluation of arm's length charge*. Whether the amount charged in a contingent-payment arrangement is arm's length will be evaluated in accordance with this section and other applicable regulations under section 482. In evaluating whether the amount charged in a contingent-payment arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient is arm's length, the charge determined under the rules of §§ 1.482-3 and 1.482-4 for the transfer of similar property may be considered. See § 1.482-1(f)(2)(ii).

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

Example 1. (i) Company X is a member of a controlled group that has operated in the pharmaceutical sector for many years. In year 1, Company X enters into a written services agreement with Company Y, another member of the controlled group, whereby Company X will perform certain research and development activities for Company Y. The parties enter into the agreement before Company X undertakes any of

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the research and development activities covered by the agreement. At the time the agreement is entered into, the possibility that any new products will be developed is highly uncertain and the possible market or markets for any products that may be developed are not known and cannot be estimated with any reliability. Under the agreement, Company Y will own any patent or other rights that result from the activities of Company X under the agreement and Company Y will make payments to Company X only if such activities result in commercial sales of one or more derivative products. In that event, Company Y will pay Company X, for a specified period, $x\%$ of Company Y's gross sales of each of such products. Payments are required with respect to each jurisdiction in which Company Y has sales of such a derivative product, beginning with the first year in which the sale of a product occurs in the jurisdiction and continuing for six additional years with respect to sales of that product in that jurisdiction.

(ii) As a result of research and development activities performed by Company X for Company Y in years 1 through 4, a compound is developed that may be more effective than existing medications in the treatment of certain conditions. Company Y registers the patent rights with respect to the compound in several jurisdictions in year 4. In year 6, Company Y begins commercial sales of the product in Jurisdiction A and, in that year, Company Y makes the payment to Company X that is required under the agreement. Sales of the product continue in Jurisdiction A in years 7 through 9 and Company Y makes the payments to Company X in years 7 through 9 that are required under the agreement.

(iii) The years under examination are years 6 through 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the conditions of paragraph (i)(2) of this section are met and whether the arrangement, including the specified contingency and basis of payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment arrangement is reflected in the written agreement between Company X and Company Y; that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction; and that the basis for the payment provided for in the event such sales occur reflects the recipient's benefit and the renderer's risk. Consistent with § 1.482-1(d)(3)(ii)(B) and (iii)(B), the Commissioner determines that the parties' conduct over the term of the agreement has been consistent with their contractual allocation of risk; that Company X has the

financial capacity to bear the risk that its research and development services may be unsuccessful and that it may not receive compensation for such services; and that Company X exercises managerial and operational control over the research and development, such that it is reasonable for Company X to assume the risk of those activities. Based on all these facts, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance.

(iv) In determining whether the amount charged under the contingent-payment arrangement in each of years 6 through 9 is arm's length, the Commissioner evaluates under this section and other applicable rules under section 482 the compensation paid in each year for the research and development services. This analysis takes into account that under the contingent-payment terms Company X bears the risk that it might not receive payment for its services in the event that those services do not result in marketable products and the risk that the magnitude of its payment depends on the magnitude of product sales, if any. The Commissioner also considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risk and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, in evaluating whether the compensation of $x\%$ of gross sales that is paid to Company X during the first four years of commercial sales of derivative products is arm's length, the Commissioner may consider the royalties (or other consideration) charged for intangible property that are comparable to those incorporated in the derivative products and that resulted from Company X's research and development activities under the contingent-payment arrangement.

Example 2. (i) The facts are the same as in *Example 1*, except that no commercial sales ever materialize with regard to the patented compound so that, consistent with the agreement, Company Y makes no payments to Company X in years 6 through 9.

(ii) Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is consistent with economic substance, and the result (no payments in years 6 through 9) is consistent with an arm's length result.

Example 3. (i) The facts are the same as in *Example 1*, except that, in the event that Company X's activities result in commercial sales of one or more derivative products by Company Y, Company Y will pay Company X a fee equal to the research and development costs borne by Company X plus an amount

equal to $x\%$ of such costs, with the payment to be made in the first year in which any such sales occur. The $x\%$ markup on costs is within the range, ascertainable in year 1, of markups on costs of independent contract researchers that are compensated under terms that unconditionally obligate the recipient to pay for the activities performed in the tax accounting period in which the service is rendered. In year 6, Company Y makes the single payment to Company X that is required under the arrangement.

(ii) The years under examination are years 6 through 9. In evaluating whether the contingent-payment terms will be recognized, the Commissioner considers whether the requirements of paragraph (i)(2) of this section were met at the time the written agreement was entered into and whether the arrangement, including the specified contingency and basis for payment, is consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment terms are reflected in the written agreement between Company X and Company Y and that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction. However, in this case, the Commissioner determines that the basis for payment provided for in the event such sales occur (costs of the services plus $x\%$, representing the markup for contract research in the absence of any non-payment risk) does not reflect the recipient's benefit and the renderer's risks in the controlled services transaction. Based on all the facts and circumstances, the Commissioner determines that the contingent-payment arrangement is not consistent with economic substance.

(iii) Accordingly, the Commissioner determines to exercise its authority to impute contingent-payment contractual terms that accord with economic substance, pursuant to paragraph (i)(3) of this section and § 1.482-1(d)(3)(ii)(B). In this regard, the Commissioner takes into account that at the time the arrangement was entered into, the possibility that any new products would be developed was highly uncertain and the possible market or markets for any products that may be developed were not known and could not be estimated with any reliability. In such circumstances, it is reasonable to conclude that one possible basis of payment, in order to reflect the recipient's benefit and the renderer's risks, would be a charge equal to a percentage of commercial sales of one or more derivative products that result from the research and development activities. The Commissioner in this case may impute terms that require Company Y to pay Company X a percentage of sales of the products devel-

oped under the agreement in each of years 6 through 9.

(iv) In determining an appropriate arm's length charge under such imputed contractual terms, the Commissioner conducts an analysis under this section and other applicable rules under section 482, and considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risks and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, for purposes of its determination, the Commissioner may consider the royalties (or other consideration) charged for intangible property that are comparable to those incorporated in the derivative products that resulted from Company X's research and development activities under the contingent-payment arrangement.

(j) *Total services costs.* For purposes of this section, total services costs means all costs of rendering those services for which total services costs are being determined. Total services costs include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated in accordance with the principles of paragraph (k)(2) of this section to, the services. In general, costs for this purpose should comprise provision for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not necessarily be conclusive regarding inclusion of costs in total services costs. Total services costs do not include interest expense, foreign income taxes (as defined in § 1.901-2(a)), or domestic income taxes.

(k) *Allocation of costs—(1) In general.* In any case where the renderer's activity that results in a benefit (within the meaning of paragraph (l)(3) of this section) for one recipient in a controlled services transaction also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this section

in the controlled services transaction is determined under a method that makes reference to costs, costs must be allocated among the portions of the activity performed for the benefit of the first mentioned recipient and such other members of the controlled group under this paragraph (k). The principles of this paragraph (k) must also be used whenever it is appropriate to allocate and apportion any class of costs (for example, overhead costs) in order to determine the total services costs of rendering the services. In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate.

(2) *Appropriate method of allocation and apportionment*—(i) *Reasonable method standard*. Any reasonable method may be used to allocate and apportion costs under this section. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, 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 applying reasonable departmental overhead rates. Allocations and apportionments of costs must be made on the basis of the full cost, as opposed to the incremental cost.

(ii) *Use of general practices*. The practices used by the taxpayer to apportion costs in connection with 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 will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Commissioner. 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 in apportioning costs among themselves will also be considered if the relationships with the foreign members are com-

parable to the relationships among the domestic members of the controlled 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 the controlled group, such domestic apportionment practice will be considered in determining the allocations to be made to the foreign members.

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

Example 1. Company A pays an annual license fee of 500x to an uncontrolled taxpayer for unlimited use of a database within the corporate group. Under the terms of the license with the uncontrolled taxpayer, Company A is permitted to use the database for its own use and in rendering research services to its subsidiary, Company B. Company B obtains benefits from the database that are similar to those that it would obtain if it had independently licensed the database from the uncontrolled taxpayer. Evaluation of the arm's length charge (under a method in which costs are relevant) to Company B for the controlled services that incorporate use of the database must take into account the full amount of the license fee of 500x paid by Company A, as reasonably allocated and apportioned to the relevant benefits, although the incremental use of the database for the benefit of Company B did not result in an increase in the license fee paid by Company A.

Example 2. (i) Company A is a consumer products company located in the United States. Companies B and C are wholly-owned subsidiaries of Company A and are located in Countries B and C, respectively. Company A and its subsidiaries manufacture products for sale in their respective markets. Company A hires a consultant who has expertise regarding a manufacturing process used by Company A and its subsidiary, Company B. Company C, the Country C subsidiary, uses a different manufacturing process, and accordingly will not receive any benefit from the outside consultant hired by Company A. In allocating and apportioning the cost of hiring the outside consultant (100), Company A determines that sales constitute the most appropriate allocation key.

(ii) Company A and its subsidiaries have the following sales:

Company	A	B	C	Total
Sales	400	100	200	700

(iii) Because Company C does not obtain any benefit from the consultant, none of the costs are allocated to it. Rather, the costs of 100 are allocated and apportioned ratably to Company A and Company B as the entities that obtain a benefit from the campaign, based on the total sales of those entities (500). An appropriate allocation of the costs of the consultant is as follows:

Company	A	B	Total
Allocation	400/500	100/500	
Amount	80	20	100

(1) *Controlled services transaction*—(1) *In general*. A controlled services transaction includes any activity (as defined in paragraph (1)(2) of this section) by one member of a group of controlled taxpayers (the renderer) that results in a benefit (as defined in paragraph (1)(3) of this section) to one or more other members of the controlled group (the recipient(s)).

(2) *Activity*. An activity includes the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making available to the recipient any property or other resources of the renderer.

(3) *Benefit*—(i) *In general*. An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity. A benefit may result to the owner of in-

tangible property if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible property. Paragraphs (1)(3)(ii) through (v) of this section provide guidelines that indicate the presence or absence of a benefit for the activities in the controlled services transaction.

(ii) *Indirect or remote benefit*. An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay, on either a fixed or contingent-payment basis, an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose. The determination whether the benefit from an activity is indirect or remote is based on the nature of the activity and the situation of the recipient, taking into consideration all facts and circumstances.

(iii) *Duplicative activities*. If an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.

(iv) *Shareholder activities*. An activity is not considered to provide a benefit if the sole effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. Activities in the nature of day-to-day management generally do not relate to protection of the renderer's capital investment. Based on analysis of the facts and circumstances, activities in connection with a corporate reorganization may be

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considered to provide a benefit to one or more controlled taxpayers.

(v) *Passive association.* A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

(4) *Disaggregation of transactions.* A controlled services transaction may be analyzed as two separate transactions for purposes of determining the arm's length consideration, if that analysis is the most reliable means of determining the arm's length consideration for the controlled services transaction. *See* the best method rule under § 1.482-1(c).

(5) *Examples.* The principles of this paragraph (1) are illustrated by the following examples. In each example, assume that Company X is a U.S. corporation and Company Y is a wholly-owned subsidiary of Company X in Country B.

Example 1. In general. In developing a worldwide advertising and promotional campaign for a consumer product, Company X pays for and obtains designation as an official sponsor of the Olympics. This designation allows Company X and all its subsidiaries, including Company Y, to identify themselves as sponsors and to use the Olympic logo in advertising and promotional campaigns. The Olympic sponsorship campaign generates benefits to Company X, Company Y, and other subsidiaries of Company X.

Example 2. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X implements certain changes in its management structure and the compensation of managers of divisions located in the United States. No changes were recommended or considered for Company Y in Country B. The internal study and the resultant changes in its management may increase the competitiveness and overall efficiency of Company X. Any benefits to Company Y as a result of the study are, however, indirect or remote. Consequently, Company Y is not considered to obtain a benefit from the study.

Example 3. Indirect or remote benefit. Based on recommendations contained in a study performed by its internal staff, Company X decides to make changes to the management structure and management compensation of its subsidiaries, in order to increase their

profitability. As a result of the recommendations in the study, Company X implements substantial changes in the management structure and management compensation scheme of Company Y. The study and the changes implemented as a result of the recommendations are anticipated to increase the profitability of Company X and its subsidiaries. The increased management efficiency of Company Y that results from these changes is considered to be a specific and identifiable benefit, rather than remote or speculative.

Example 4. Duplicative activities. At its corporate headquarters in the United States, Company X performs certain treasury functions for Company X and for its subsidiaries, including Company Y. These treasury functions include raising capital, arranging medium and long-term financing for general corporate needs, including cash management. Under these circumstances, the treasury functions performed by Company X do not duplicate the functions performed by Company Y's staff. Accordingly, Company Y is considered to obtain a benefit from the functions performed by Company X.

Example 5. Duplicative activities. The facts are the same as in *Example 4*, except that Company Y's functions include ensuring that the financing requirements of its own operations are met. Analysis of the facts and circumstances indicates that Company Y independently administers all financing and cash-management functions necessary to support its operations, and does not utilize financing obtained by Company X. Under the circumstances, the treasury functions performed by Company X are duplicative of similar functions performed by Company Y's staff, and the duplicative functions do not enhance Company Y's position. Accordingly, Company Y is not considered to obtain a benefit from the duplicative activities performed by Company X.

Example 6. Duplicative activities. Company X's in-house legal staff has specialized expertise in several areas, including intellectual property. The intellectual property legal staff specializes in technology licensing, patents, copyrights, and negotiating and drafting intellectual property agreements. Company Y is involved in negotiations with an unrelated party to enter into a complex joint venture that includes multiple licenses and cross-licenses of patents and copyrights. Company Y retains outside counsel that specializes in intellectual property law to review the transaction documents. Company Y does not have in-house counsel of its own to review intellectual property transaction documents. Outside counsel advises that the terms for the proposed transaction are advantageous to Company Y and that the contracts are valid and fully enforceable. Company X's intellectual property legal staff possess valuable knowledge of Company Y's

patents and technological achievements. They are capable of identifying particular scientific attributes protected under patent that strengthen Company Y's negotiating position, and of discovering flaws in the patents offered by the unrelated party. To reduce risk associated with the transaction, Company X's intellectual property legal staff reviews the transaction documents before Company Y executes the contracts. Company X's intellectual property legal staff also separately evaluates the patents and copyrights with respect to the licensing arrangements and concurs in the opinion provided by outside counsel. The activities performed by Company X substantially duplicate the legal services obtained by Company Y, but they also reduce risk associated with the transaction in a way that confers an additional benefit on Company Y.

Example 7. Shareholder activities. Company X is a publicly held corporation. U.S. laws and regulations applicable to publicly held corporations such as Company X require the preparation and filing of periodic reports that show, among other things, profit and loss statements, balance sheets, and other material financial information concerning the company's operations. Company X, Company Y and each of the other subsidiaries maintain their own separate accounting departments that record individual transactions and prepare financial statements in accordance with their local accounting practices. Company Y, and the other subsidiaries, forward the results of their financial performance to Company X, which analyzes and compiles these data into periodic reports in accordance with U.S. laws and regulations. Because Company X's preparation and filing of the reports relate solely to its role as an investor of capital or shareholder in Company Y or to its compliance with reporting, legal, or regulatory requirements, or both, these activities constitute shareholder activities and therefore Company Y is not considered to obtain a benefit from the preparation and filing of the reports.

Example 8. Shareholder activities. The facts are the same as in *Example 7*, except that Company Y's accounting department maintains a general ledger recording individual transactions, but does not prepare any financial statements (such as profit and loss statements and balance sheets). Instead, Company Y forwards the general ledger data to Company X, and Company X analyzes and compiles financial statements for Company Y, as well as for Company X's overall operations, for purposes of complying with U.S. reporting requirements. Company Y is subject to reporting requirements in Country B similar to those applicable to Company X in the United States. Much of the data that Company X analyzes and compiles regarding Company Y's operations for purposes of complying with the U.S. reporting requirements

are made available to Company Y for its use in preparing reports that must be filed in Country B. Company Y incorporates these data, after minor adjustments for differences in local accounting practices, into the reports that it files in Country B. Under these circumstances, because Company X's analysis and compilation of Company Y's financial data does not relate solely to its role as an investor of capital or shareholder in Company Y, or to its compliance with reporting, legal, or regulatory requirements, or both, these activities do not constitute shareholder activities.

Example 9. Shareholder activities. Members of Company X's internal audit staff visit Company Y on a semiannual basis in order to review the subsidiary's adherence to internal operating procedures issued by Company X and its compliance with U.S. anti-bribery laws, which apply to Company Y on account of its ownership by a U.S. corporation. Because the sole effect of the reviews by Company X's audit staff is to protect Company X's investment in Company Y, or to facilitate Company X's compliance with U.S. anti-bribery laws, or both, the visits are shareholder activities and therefore Company Y is not considered to obtain a benefit from the visits.

Example 10. Shareholder activities. Country B recently enacted legislation that changed the foreign currency exchange controls applicable to foreign shareholders of Country B corporations. Company X concludes that it may benefit from changing the capital structure of Company Y, thus taking advantage of the new foreign currency exchange control laws in Country B. Company X engages an investment banking firm and a law firm to review the Country B legislation and to propose possible changes to the capital structure of Company Y. Because Company X's retention of the firms facilitates Company Y's ability to pay dividends and other amounts and has the sole effect of protecting Company X's investment in Company Y, these activities constitute shareholder activities and Company Y is not considered to obtain a benefit from the activities.

Example 11. Shareholder activities. The facts are the same as in *Example 10*, except that Company Y bears the full cost of retaining the firms to evaluate the new foreign currency control laws in Country B and to make appropriate changes to its stock ownership by Company X. Company X is considered to obtain a benefit from the rendering by Company Y of these activities, which would be shareholder activities if conducted by Company X (see *Example 10*).

Example 12. Shareholder activities. The facts are the same as in *Example 10*, except that the new laws relate solely to corporate governance in Country B, and Company X retains the law firm and investment banking

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firm in order to evaluate whether restructuring would increase Company Y's profitability, reduce the number of legal entities in Country B, and increase Company Y's ability to introduce new products more quickly in Country B. Because Company X retained the law firm and the investment banking firm primarily to enhance Company Y's profitability and the efficiency of its operations, and not solely to protect Company X's investment in Company Y or to facilitate Company X's compliance with Country B's corporate laws, or to both, these activities do not constitute shareholder activities.

Example 13. Shareholder activities. Company X establishes detailed personnel policies for its subsidiaries, including Company Y. Company X also reviews and approves the performance appraisals of Company Y's executives, monitors levels of compensation paid to all Company Y personnel, and is involved in hiring and firing decisions regarding the senior executives of Company Y. Because this personnel-related activity by Company X involves day-to-day management of Company Y, this activity does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, and therefore does not constitute a shareholder activity.

Example 14. Shareholder activities. Each year, Company X conducts a two-day retreat for its senior executives. The purpose of the retreat is to refine the long-term business strategy of Company X and its subsidiaries, including Company Y, and to produce a confidential strategy statement. The strategy statement identifies several potential growth initiatives for Company X and its subsidiaries and lists general means of increasing the profitability of the company as a whole. The strategy statement is made available without charge to Company Y and the other subsidiaries of Company X. Company Y independently evaluates whether to implement some, all, or none of the initiatives contained in the strategy statement. Because the preparation of the strategy statement does not relate solely to Company X's role as an investor of capital or a shareholder of Company Y, the expense of preparing the document is not a shareholder expense.

Example 15. Passive association/benefit. Company X is the parent corporation of a large controlled group that has been in operation in the information-technology sector for ten years. Company Y is a small corporation that was recently acquired by the Company X controlled group from local Country B owners. Several months after the acquisition of Company Y, Company Y obtained a contract to redesign and assemble the information-technology networks and systems of a large financial institution in Country B. The project was significantly larger and more complex than any other project undertaken

to date by Company Y. Company Y did not use Company X's marketing intangible property to solicit the contract, and Company X had no involvement in the solicitation, negotiation, or anticipated execution of the contract. For purposes of this section, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group because the ability of Company Y to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by the Company X controlled group, was due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group.

Example 16. Passive association/benefit. The facts are the same as in *Example 15*, except that Company X executes a performance guarantee with respect to the contract, agreeing to assist in the project if Company Y fails to meet certain milestones. This performance guarantee allowed Company Y to obtain the contract on materially more favorable terms than otherwise would have been possible. Company Y is considered to obtain a benefit from Company X's execution of the performance guarantee.

Example 17. Passive association/benefit. The facts are the same as in *Example 15*, except that Company X began the process of negotiating the contract with the financial institution in Country B before acquiring Company Y. Once Company Y was acquired by Company X, the contract with the financial institution was entered into by Company Y. Company Y is considered to obtain a benefit from Company X's negotiation of the contract.

Example 18. Passive association/benefit. The facts are the same as in *Example 15*, except that Company X sent a letter to the financial institution in Country B, which represented that Company X had a certain percentage ownership in Company Y and that Company X would maintain that same percentage ownership interest in Company Y until the contract was completed. This letter allowed Company Y to obtain the contract on more favorable terms than otherwise would have been possible. Since this letter from Company X to the financial institution simply affirmed Company Y's status as a member of the controlled group and represented that this status would be maintained until the contract was completed, Company Y is not considered to obtain a benefit from Company X's furnishing of the letter.

Example 19. Passive association/benefit. (i) S is a company that supplies plastic containers to companies in various industries. S establishes the prices for its containers through a price list that offers customers discounts based solely on the volume of containers purchased.

(ii) Company X is the parent corporation of a large controlled group in the information technology sector. Company Y is a wholly-owned subsidiary of Company X located in Country B. Company X and Company Y both purchase plastic containers from unrelated supplier S. In year 1, Company X purchases 1 million units and Company Y purchases 100,000 units. S, basing its prices on purchases by the entire group, completes the order for 1.1 million units at a price of \$0.95 per unit, and separately bills and ships the orders to each company. Companies X and Y undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iii) R1 and its wholly-owned subsidiary R2 are a controlled group of taxpayers (unrelated to Company X or Company Y) each of which carries out functions comparable to those of Companies X and Y and undertakes purchases of plastic containers from supplier S, identical to those purchased from S by Company X and Company Y, respectively. S, basing its prices on purchases by the entire group, charges R1 and R2 \$0.95 per unit for the 1.1 million units ordered. R1 and R2 undertake no bargaining with supplier S with respect to the price charged, and purchase no other products from supplier S.

(iv) U is an uncontrolled taxpayer that carries out comparable functions and undertakes purchases of plastic containers from supplier S identical to Company Y. U is not a member of a controlled group, undertakes no bargaining with supplier S with respect to the price charged, and purchases no other products from supplier S. U purchases 100,000 plastic containers from S at the price of \$1.00 per unit.

(v) Company X charges Company Y a fee of \$5,000, or \$0.05 per unit of plastic containers purchased by Company Y, reflecting the fact that Company Y receives the volume discount from supplier S.

(vi) In evaluating the fee charged by Company X to Company Y, the Commissioner considers whether the transactions between R1, R2, and S or the transactions between U and S provide a more reliable measure of the transactions between Company X, Company Y and S. The Commissioner determines that Company Y's status as a member of a controlled group should be taken into account for purposes of evaluating comparability of the transactions, and concludes that the transactions between R1, R2, and S are more reliably comparable to the transactions between Company X, Company Y, and S. The comparable charge for the purchase was \$0.95 per unit. Therefore, obtaining the plastic containers at a favorable rate (and the resulting \$5,000 savings) is entirely due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group. Con-

sequently, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group.

Example 20. Disaggregation of transactions.
(i) X, a domestic corporation, is a pharmaceutical company that develops and manufactures ethical pharmaceutical products. Y, a Country B corporation, is a distribution and marketing company that also performs clinical trials for X in Country B. Because Y does not possess the capability to conduct the trials, it contracts with a third party to undertake the trials at a cost of \$100. Y also incurs \$25 in expenses related to the third-party contract (for example, in hiring and working with the third party).

(ii) Based on a detailed functional analysis, the Commissioner determines that Y performed functions beyond merely facilitating the clinical trials for X, such as audit controls of the third party performing those trials. In determining the arm's length price, the Commissioner may consider a number of alternatives. For example, for purposes of determining the arm's length price, the Commissioner may determine that the intercompany service is most reliably analyzed on a disaggregated basis as two separate transactions: in this case, the contract between Y and the third party could constitute an internal CUSP with a price of \$100. Y would be further entitled to an arm's length remuneration for its facilitating services. If the most reliable method is one that provides a markup on Y's costs, then "total services cost" in this context would be \$25. Alternatively, the Commissioner may determine that the intercompany service is most reliably analyzed as a single transaction, based on comparable uncontrolled transactions involving the facilitation of similar clinical trial services performed by third parties. If the most reliable method is one that provides a markup on all of Y's costs, and the base of the markup determined by the comparable companies includes the third-party clinical trial costs, then such a markup would be applied to Y's total services cost of \$125.

Example 21. Disaggregation of transactions.
(i) X performs a number of administrative functions for its subsidiaries, including Y, a distributor of widgets in Country B. These services include those relating to working capital (inventory and accounts receivable/payable) management. To facilitate provision of these services, X purchases an ERP system specifically dedicated to optimizing working capital management. The system, which entails significant third-party costs and which includes substantial intellectual property relating to its software, costs \$1,000.

(ii) Based on a detailed functional analysis, the Commissioner determines that in providing administrative services for Y, X performed functions beyond merely operating

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the ERP system itself, since X was effectively using the ERP as an input to the administrative services it was providing to Y. In determining arm's length price for the services, the Commissioner may consider a number of alternatives. For example, if the most reliable uncontrolled data is derived from companies that use similar ERP systems purchased from third parties to perform similar administrative functions for uncontrolled parties, the Commissioner may determine that a CPM is the best method for measuring the functions performed by X, and, in addition, that a markup on total services costs, based on the markup from the comparable companies, is the most reliable PLI. In this case, total services cost, and the basis for the markup, would include appropriate reflection of the ERP costs of \$1,000. Alternatively, X's functions may be most reliably measured based on comparable uncontrolled companies that perform similar administrative functions using their customers' own ERP systems. Under these circumstances, the total services cost would equal X's costs of providing the administrative services excluding the ERP cost of \$1,000.

(m) *Coordination with transfer pricing rules for other transactions*—(1) *Services transactions that include other types of transactions.* A transaction structured as a controlled services transaction may include other elements for which a separate category or categories of methods are provided, such as a loan or advance, a rental, or a transfer of tangible or intangible property. See §§ 1.482-1(b)(2) and 1.482-2(a), (c), and (d). Whether such an integrated transaction is evaluated as a controlled services transaction under this section or whether one or more elements should be evaluated separately under other sections of the section 482 regulations depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, an integrated transaction of this type may be evaluated under this section and its separate elements need not be evaluated separately, provided that each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length result in the controlled transaction. See § 1.482-1(d)(3).

(2) *Services transactions that effect a transfer of intangible property.* A trans-

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action structured as a controlled services transaction may in certain cases include an element that constitutes the transfer of intangible property or may result in a transfer, in whole or in part, of intangible property. Notwithstanding paragraph (m)(1) of this section, if such element relating to intangible property is material to the evaluation, the arm's length result for the element of the transaction that involves intangible property must be corroborated or determined by an analysis under § 1.482-4.

(3) *Coordination with rules governing cost sharing arrangements.* Section 1.482-7 provides the specific methods to be used to determine arm's length results of controlled transactions in connection with a cost sharing arrangement. This section provides the specific methods to be used to determine arm's length results of a controlled service transaction, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by § 1.482-7. In the case of such an arrangement, consideration of the principles, methods, comparability, and reliability considerations set forth in § 1.482-7 is relevant in determining the best method, including an unspecified method, under this section, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

(4) *Other types of transactions that include controlled services transactions.* A transaction structured other than as a controlled services transaction may include one or more elements for which separate pricing methods are provided in this section. Whether such an integrated transaction is evaluated under another section of the section 482 regulations or whether one or more elements should be evaluated separately under this section depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, a single method may be applied to such an integrated transaction, and the separate services component of the transaction need not be separately analyzed under this section, provided that the controlled services may be adequately accounted for in

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evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length results in the controlled transaction. See § 1.482-1(d)(3).

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

Example 1. (i) U.S. parent corporation Company X enters into an agreement to maintain equipment of Company Y, a foreign subsidiary. The maintenance of the equipment requires the use of spare parts. The cost of the spare parts necessary to maintain the equipment amounts to approximately 25 percent of the total costs of maintaining the equipment. Company Y pays a fee that includes a charge for labor and parts.

(ii) Whether this integrated transaction is evaluated as a controlled services transaction or is evaluated as a controlled services transaction and the transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. If it is not possible to find comparable uncontrolled services transactions that involve similar services and tangible property transfers as the controlled transaction between Company X and Company Y, it will be necessary to determine the arm's length charge for the controlled services, and then to evaluate separately the arm's length charge for the tangible property transfers under § 1.482-1 and §§ 1.482-3 through 1.482-6. Alternatively, it may be possible to apply the comparable profits method of § 1.482-5 to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm's length result if uncontrolled parties are identified that perform similar, combined functions of maintaining and providing spare parts for similar equipment.

Example 2. (i) U.S. parent corporation Company X sells industrial equipment to its foreign subsidiary, Company Y. In connection with this sale, Company X renders to Company Y services that consist of demonstrating the use of the equipment and assisting in the effective start-up of the equipment. Company X structures the integrated transaction as a sale of tangible property and determines the transfer price under the comparable uncontrolled price method of § 1.482-3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. In this case, the controlled services

may be similar to services rendered in the transactions used to determine the comparable uncontrolled price, or they may appropriately be considered a difference between the controlled transaction and comparable transactions with a definite and reasonably ascertainable effect on price for which appropriate adjustments can be made. See § 1.482-1(d)(3)(ii)(A)(6). In either case, application of the comparable uncontrolled price method to evaluate the integrated transaction may provide a reliable measure of an arm's length result, and application of a separate transfer pricing method for the controlled services element of the transaction is not necessary.

Example 3. (i) The facts are the same as in *Example 2* except that, after assisting Company Y in start-up, Company X also renders ongoing services, including instruction and supervision regarding Company Y's ongoing use of the equipment. Company X structures the entire transaction, including the incremental ongoing services, as a sale of tangible property, and determines the transfer price under the comparable uncontrolled price method of § 1.482-3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. It may not be possible to identify comparable uncontrolled transactions in which a seller of merchandise renders services similar to the ongoing services rendered by Company X to Company Y. In such a case, the incremental services in connection with ongoing use of the equipment could not be taken into account as a comparability factor because they are not similar to the services rendered in connection with sales of similar tangible property. Accordingly, it may be necessary to evaluate separately the transfer price for such services under this section in order to produce the most reliable measure of an arm's length result. Alternatively, it may be possible to apply the comparable profits method of § 1.482-5 to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm's length result if uncontrolled parties are identified that perform the combined functions of selling equipment and rendering ongoing after-sale services associated with such equipment. In that case, it would not be necessary to separately evaluate the transfer price for the controlled services under this section.

Example 4. (i) Company X, a U.S. corporation, and Company Y, a foreign corporation, are members of a controlled group. Both

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companies perform research and development activities relating to integrated circuits. In addition, Company Y manufactures integrated circuits. In years 1 through 3, Company X engages in substantial research and development activities, gains significant know-how regarding the development of a particular high-temperature resistant integrated circuit, and memorializes that research in a written report. In years 1 through 3, Company X generates overall net operating losses as a result of the expenditures associated with this research and development effort. At the beginning of year 4, Company X enters into a technical assistance agreement with Company Y. As part of this agreement, the researchers from Company X responsible for this project meet with the researchers from Company Y and provide them with a copy of the written report. Three months later, the researchers from Company Y apply for a patent for a high-temperature resistant integrated circuit based in large part upon the know-how obtained from the researchers from Company X.

(ii) The controlled services transaction between Company X and Company Y includes an element that constitutes the transfer of intangible property (such as, know-how). Because the element relating to the intangible property is material to the arm's length evaluation, the arm's length result for that element must be corroborated or determined by an analysis under § 1.482-4.

(6) *Global dealing operations.* [Reserved]

(n) *Effective/applicability date*—(1) *In general.* This section is generally applicable for taxable years beginning after July 31, 2009. In addition, a person may elect to apply the provisions of this section to earlier taxable years. See paragraph (n)(2) of this section.

(2) *Election to apply regulations to earlier taxable years*—(i) *Scope of election.* A taxpayer may elect to apply § 1.482-1(a)(1), (b)(2)(i), (d)(3)(ii)(C) *Examples 3 through 6*, (d)(3)(v), (f)(2)(ii)(A), (f)(2)(iii)(B), (g)(4)(i), (g)(4)(iii) *Example 1*, (i), (j)(6)(i) and (j)(6)(ii), § 1.482-2(b), (f)(1) and (2), § 1.482-4(f)(3)(i)(A), (f)(3)(ii) *Examples 1 and 2*, (f)(4), (h)(1) and (2), § 1.482-6(c)(2)(ii)(B)(1), (c)(2)(ii)(D), (c)(3)(i)(A), (c)(3)(i)(B), (c)(3)(ii)(D), and (d), § 1.482-8(b) *Examples 10 through 12*, (c)(1) and (c)(2), § 1.482-9(a) through (m)(2), and (m)(4) through (n)(2), § 1.861-8(a)(5)(ii), (b)(3), (e)(4), (f)(4)(i), (g) *Examples 17, 18, and 30*, § 1.6038A-3(a)(3) *Example 4* and (i), § 1.6662-6(d)(2)(ii)(B), (d)(2)(iii)(B)(4), (d)(2)(iii)(B)(6), and (g), and § 31.3121(s)-1(c)(2)(iii) and (d) of this chapter to any taxable year beginning

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after September 10, 2003. Such election requires that all of the provisions of such sections be applied to such taxable year and all subsequent taxable years (earlier taxable years) of the taxpayer making the election.

(ii) *Effect of election.* An election to apply the regulations to earlier taxable years has no effect on the limitations on assessment and collection or on the limitations on credit or refund (see Chapter 66 of the Internal Revenue Code).

(iii) *Time and manner of making election.* An election to apply the regulations to earlier taxable years must be made by attaching a statement to the taxpayer's timely filed U.S. tax return (including extensions) for its first taxable year beginning after July 31, 2009.

(iv) *Revocation of election.* An election to apply the regulations to earlier taxable years may not be revoked without the consent of the Commissioner.

[T.D. 9456, 74 FR 38846, Aug. 4, 2009, as amended by 74 FR 46345, Sept. 9, 2009; T.D. 9568, 76 FR 80136, Dec. 22, 2011]

§ 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.

(c) *Exceptions to and limitations on the application of section 483*—(1) *In general*. Sections 483(d), 1274(c)(4), and 1275(b)

contain exceptions to and limitations on the application of section 483.

(2) *Sales price of \$3,000 or less*. Section 483(d)(2) applies only if it can be determined at the time of the sale or exchange that the sales price cannot exceed \$3,000, regardless of whether the sales price eventually paid for the property is less than \$3,000.

(3) *Other exceptions and limitations*—(i) *Certain transfers subject to section 1041*. Section 483 does not apply to any transfer of property subject to section 1041 (relating to transfers of property between spouses or incident to divorce).

(ii) *Treatment of certain obligees*. Section 483 does not apply to an obligee under a contract for the sale or exchange of personal use property (within the meaning of section 1275(b)(3)) in the hands of the obligor and that evidences a below-market loan described in section 7872(c)(1).

(iii) *Transactions involving certain demand loans*. Section 483 does not apply to any payment under a contract that evidences a demand loan that is a below-market loan described in section 7872(c)(1).

(iv) *Transactions involving certain annuity contracts*. Section 483 does not apply to any payment under an annuity contract described in section 1275(a)(1)(B) (relating to annuity contracts excluded from the definition of debt instrument).

(v) *Options*. Section 483 does not apply to any payment under an option to buy or sell property.

(d) *Assumptions*. If a debt instrument is assumed, or property is taken subject to a debt instrument, in connection with a sale or exchange of property, the debt instrument is treated for purposes of section 483 in a manner consistent with the rules of §1.1274-5.

(e) *Aggregation rule*. For purposes of section 483, all sales or exchanges that are part of the same transaction (or a series of related transactions) are treated as a single sale or exchange, and all contracts calling for deferred payments arising from the same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts and to sales

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or exchanges involving a single buyer and a single seller.

(f) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4805, Feb. 2, 1994]

§ 1.483-2 Unstated interest.

(a) *In general—(1) Adequate stated interest.* For purposes of section 483, a contract has unstated interest if the contract does not provide for adequate stated interest. A contract does not provide for adequate stated interest if the sum of the deferred payments exceeds—

(i) The sum of the present values of the deferred payments and the present values of any stated interest payments due under the contract; or

(ii) In the case of a cash method debt instrument (within the meaning of section 1274A(c)(2)) received in exchange for property in a potentially abusive situation (as defined in § 1.1274-3), the fair market value of the property reduced by the fair market value of any consideration other than the debt instrument, and reduced by the sum of all principal payments that are not deferred payments.

(2) *Amount of unstated interest.* For purposes of section 483, unstated interest means an amount equal to the excess of the sum of the deferred payments over the amount described in paragraph (a)(1)(i) or (a)(1)(ii) of this section, whichever is applicable.

(b) *Operational rules—(1) In general.* For purposes of paragraph (a) of this section, rules similar to those in § 1.1274-2 apply to determine whether a contract has adequate stated interest and the amount of unstated interest, if any, on the contract.

(2) *Present value.* For purposes of paragraph (a) of this section, the present value of any deferred payment or interest payment is determined by discounting the payment from the date it becomes due to the date of the sale or exchange at the test rate of interest applicable to the contract in accordance with § 1.483-3.

(c) *Examples.* The following examples illustrate the rules of this section.

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Example 1. Contract that does not have adequate stated interest. On January 1, 1995, A sells B nonpublicly traded property under a contract that calls for a \$100,000 payment of principal on January 1, 2005, and 10 annual interest payments of \$9,000 on January 1 of each year, beginning on January 1, 1996. Assume that the test rate of interest is 9.2 percent, compounded annually. The contract does not provide for adequate stated interest because it does not provide for interest equal to 9.2 percent, compounded annually. The present value of the deferred payments is \$98,727.69. As a result, the contract has unstated interest of \$1,272.31 (\$100,000 – \$98,727.69).

Example 2. Contract that does not have adequate stated interest; no interest for initial short period. On May 1, 1996, A sells B nonpublicly traded property under a contract that calls for B to make a principal payment of \$200,000 on December 31, 1998, and semiannual interest payments of \$9,000, payable on June 30 and December 31 of each year, beginning on December 31, 1996. Assume that the test rate of interest is 9 percent, compounded semiannually. Even though the contract calls for a stated rate of interest no lower than the test rate of interest, the contract does not provide for adequate stated interest because the stated rate of interest does not apply for the short period from May 1, 1996, through June 30, 1996.

Example 3. Potentially abusive situation. (i) *Facts.* In a potentially abusive situation, a contract for the sale of nonpublicly traded personal property calls for the issuance of a cash method debt instrument (as defined in section 1274A(c)(2)) with a stated principal amount of \$700,000, payable in 5 years. No other consideration is given. The debt instrument calls for annual payments of interest over its entire term at a rate of 9.2 percent, compounded annually (the test rate of interest applicable to the debt instrument). Thus, the present value of the deferred payment and the interest payments is \$700,000. Assume that the fair market value of the property is \$500,000.

(ii) *Amount of unstated interest.* A cash method debt instrument received in exchange for property in a potentially abusive situation provides for adequate stated interest only if the sum of the deferred payments under the instrument does not exceed the fair market value of the property. Because the deferred payment (\$700,000) exceeds the fair market value of the property (\$500,000), the debt instrument does not provide for adequate stated interest. Therefore, the debt instrument has unstated interest of \$200,000.

Example 4. Variable rate debt instrument with adequate stated interest; variable rate as of the issue date greater than the test rate. (i) *Facts.* A contract for the sale of nonpublicly traded property calls for the issuance of a debt instrument in the principal amount of \$75,000

due in 10 years. The debt instrument calls for interest payable semiannually at a rate of 3 percentage points above the yield on 6-month Treasury bills at the mid-point of the semiannual period immediately preceding each interest payment date. Assume that the interest rate is a qualified floating rate and that the debt instrument is a variable rate debt instrument within the meaning of §1.1275-5.

(ii) *Adequate stated interest.* Under paragraph (b)(1) of this section, rules similar to those in §1.1274-2(f) apply to determine whether the debt instrument has adequate stated interest. Assume that the test rate of interest applicable to the debt instrument is 9 percent, compounded semiannually. Assume also that the yield on 6-month Treasury bills on the date of the sale is 8.89 percent, which is greater than the yield on 6-month Treasury bills on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated. Under §1.1274-2(f), the debt instrument is tested for adequate stated interest as if it provided for a stated rate of interest of 11.89 percent (3 percent plus 8.89 percent), compounded semiannually, payable over its entire term. Because the test rate of interest is 9 percent, compounded semiannually, and the debt instrument is treated as providing for stated interest of 11.89 percent, compounded semiannually, the debt instrument provides for adequate stated interest.

(d) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4806, Feb. 2, 1994]

§ 1.483-3 Test rate of interest applicable to a contract.

(a) *General rule.* For purposes of section 483, the test rate of interest for a contract is the same as the test rate that would apply under §1.1274-4 if the contract were a debt instrument. Paragraph (b) of this section, however, provides for a lower test rate in the case of certain sales or exchanges of land between related individuals.

(b) *Lower rate for certain sales or exchanges of land between related individuals—(1) Test rate.* In the case of a qualified sale or exchange of land between related individuals (described in section 483(e)), the test rate is not greater than 6 percent, compounded semiannually, or an equivalent rate

based on an appropriate compounding period.

(2) *Special rules.* The following rules and definitions apply in determining whether a sale or exchange is a qualified sale under section 483(e):

(i) *Definition of family members.* The members of an individual's family are determined as of the date of the sale or exchange. The members of an individual's family include those individuals described in section 267(c)(4) and the spouses of those individuals. In addition, for purposes of section 267(c)(4), full effect is given to a legal adoption, ancestor means parents and grandparents, and lineal descendants means children and grandchildren.

(ii) *\$500,000 limitation.* Section 483(e) does not apply to the extent that the stated principal amount of the debt instrument issued in the sale or exchange, when added to the aggregate stated principal amount of any other debt instruments to which section 483(e) applies that were issued in prior qualified sales between the same two individuals during the same calendar year, exceeds \$500,000. See *Example 3* of paragraph (b)(3) of this section.

(iii) *Other limitations.* Section 483(e) does not apply if the parties to a contract include persons other than the related individuals and the parties enter into the contract with an intent to circumvent the purposes of section 483(e). In addition, if the property sold or exchanged includes any property other than land, section 483(e) applies only to the extent that the stated principal amount of the debt instrument issued in the sale or exchange is attributable to the land (based on the relative fair market values of the land and the other property).

(3) *Examples.* The following examples illustrate the rules of this paragraph (b).

Example 1. On January 1, 1995, A sells land to B, A's child, for \$650,000. The contract for sale calls for B to make a \$250,000 down payment and issue a debt instrument with a stated principal amount of \$400,000. Because the stated principal amount of the debt instrument is less than \$500,000, the sale is a qualified sale and section 483(e) applies to the debt instrument.

Example 2. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional

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land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of \$100,000. The stated principal amount of this debt instrument (\$100,000) when added to the stated principal amount of the prior debt instrument (\$400,000) does not exceed \$500,000. Thus, section 483(e) applies to both debt instruments.

Example 3. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of \$150,000. The stated principal amount of this debt instrument when added to the stated principal amount of the prior debt instrument (\$400,000) exceeds \$500,000. Thus, for purposes of section 483(e), the debt instrument issued in the sale of June 1, 1995, is treated as two separate debt instruments: a \$100,000 debt instrument (to which section 483(e) applies) and a \$50,000 debt instrument (to which section 1274, if otherwise applicable, applies).

(c) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4807, Feb. 2, 1994]

§ 1.483-4 Contingent payments.

(a) *In general.* This section applies to a contract for the sale or exchange of property (the overall contract) if the contract provides for one or more contingent payments and the contract is subject to section 483. This section applies even if the contract provides for adequate stated interest under § 1.483-2. If this section applies to a contract, interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to § 1.1275-4(c). Consequently, all noncontingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in § 1.1275-4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in § 1.1275-4(c)(4). However, 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

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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 includable 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 includable 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

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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,