No. 17-72922

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

AMAZON.COM, INC. AND SUBSIDIARIES,

Petitioners-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLANT

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GLOSSARY

Amazon-LUX	Amazon's affiliated Luxembourg corporations
Amazon-US	Amazon's affiliated U.S. corporations
CUT	Comparable-uncontrolled-transaction method
DCF	Discounted-cash-flow method
ER	Excerpts of record filed by the Commissioner
IRS	Internal Revenue Service
Op/ER	Tax Court opinion
R&D	Research and development

STATEMENT OF JURISDICTION

Amazon.com, Inc. is the common parent of an affiliated group of U.S. corporations (Amazon-US) that filed consolidated federal income tax returns for 2005-2006. On November 9, 2012, the IRS issued a notice of deficiency to Amazon-US for those years. (ER252A.) *See* I.R.C. § 6212(a). On December 28, 2012, within 90 days of that notice, Amazon-US timely filed a petition for redetermination in the United States Tax Court. (ER832.) *See* I.R.C. § 6213(a). The Tax Court had jurisdiction under Section 6213(a). *See* I.R.C. § 7442.

The Tax Court entered a decision on July 5, 2017. (ER208.) That decision constituted a final judgment, disposing of all claims of all parties. *See* I.R.C. § 7459(a). On September 29, 2017, within 90 days after entry of the decision, the Commissioner timely filed a notice of appeal with the Tax Court. (ER210.) *See* I.R.C. § 7483. This Court has jurisdiction under I.R.C. § 7482(a)(1).

STATEMENT OF THE ISSUE

This case concerns a U.S. taxpayer that developed highly profitable intangibles and then made them available to a newly created foreign affiliate pursuant to a cost-sharing arrangement for the

development of future intangibles. Although the U.S. taxpayer controlled the foreign affiliate, the affiliate's income was not subject to U.S. tax. Section 482 of the Internal Revenue Code and its implementing regulations require the foreign affiliate to pay the U.S. taxpayer an arm's-length amount for the use of the existing intangibles. The question presented is:

Whether the Tax Court wrongly concluded that the method utilized by the Commissioner to determine an arm's-length price for the use of the intangibles at issue violates Section 482's implementing regulations.

APPLICABLE STATUTES AND REGULATIONS

The applicable statutes and regulations are included in this brief's addendum.

STATEMENT OF THE CASE

A. Procedural overview

This case involves a multinational company that priced intercompany transactions in a manner that did not clearly reflect its income subject to U.S. taxation. Section 482 of the Internal Revenue Code is designed to prevent such behavior and grants the Commissioner

broad discretion to reallocate income among related parties by determining the arm's-length price for intercompany transactions.

The IRS utilized Section 482 to determine substantial deficiencies in Amazon-US's federal income tax for 2005 and 2006. The deficiencies stem from a cost-sharing arrangement for the development of future intangibles between Amazon-US and a newly formed foreign subsidiary (Amazon-LUX) that was intended to be a "qualified cost sharing arrangement" under Treasury's cost-sharing regulations. In entering into the arrangement, Amazon-US provided Amazon-LUX access to its entire panoply of pre-existing intangible assets. To comply with the regulations, Amazon-LUX was required to pay an arm's-length amount for the use of those pre-existing intangibles (buy-in payment). The IRS determined that Amazon-US's calculation of the buy-in payment, with a present value of $217 million, understated Amazon-LUX's buy-in obligation by over $2.7 billion.[1]

Amazon-US filed a petition in the Tax Court challenging the deficiencies. After a trial, the court concluded that neither party had determined an arm's-length price for the buy-in payment. The court

[1] *See* p. 25 n.7, *infra*. All dollar figures are approximations.

determined that the Commissioner's proposed method for computing the buy-in payment was unreasonable because it included items that (in the court's view) were outside the scope of the regulations' buy-in requirement. After making adjustments to Amazon-US's method, the court entered a decision reflecting an increased buy-in payment of $779 million. The Commissioner has appealed.

B. Regulatory overview

1. Transfer pricing

U.S. corporations operating through related enterprises, including affiliated foreign corporations, have long attempted to manipulate their intra-group transactions in order to avoid U.S. tax. For example, a U.S. corporation might allow its foreign subsidiary to operate a business overseas by using valuable intangibles created by the U.S. corporation without charging the foreign subsidiary an arm's-length price for those intangibles. If the use of the intangibles was worth $4 billion, but the U.S. corporation allowed the foreign subsidiary to use them for free, the U.S. corporation's income subject to U.S. taxation would be understated by $4 billion, a clear distortion of income.

To combat such abuse, Congress – for almost 100 years – has given the IRS the "broad authority" to evaluate the pricing of transactions between related parties (Op/ER67), and to allocate certain tax items (including gross income) between or among the parties "if [it] determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such" entities. I.R.C. § 482. Under regulations implementing Section 482, the taxable income of related parties is determined as if they had conducted their affairs in the manner of unrelated parties "dealing at arm's length." § 1.482-1(b)(1).[2] Specifically, a related-party 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." *Id.* Using the example above, if the U.S. corporation had made its valuable intangibles available to an unrelated party, it would have charged that party $4 billion for such use. Section 482 allows the IRS

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[2] All "§" references not prefaced by "I.R.C." are to the Treasury Regulations (26 C.F.R.) in effect during the tax years at issue (2005-2006).

to place the related taxpayers on par with unrelated parties and allocate $4 billion of income to the U.S. corporation.

Any transfer of property (or the use of property) between related parties must be accompanied by arm's-length consideration. The regulations divide property into two discrete categories – tangible property and intangible property. §§ 1.482-3 and 1.482-4. There is no category of property that can be transferred for free or for less than an arm's-length amount. As the regulations emphasize, the "standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." § 1.482-1(b)(1).

This case involves intangible property. The regulations broadly define intangibles to include any asset that "has substantial value independent of the services of any individual" and "derives its value not from its physical attributes but from its intellectual content or other intangibles properties." § 1.482-4(b)(6). The regulations list 28 examples of intangibles – such as patents, systems, and procedures – but make clear that intangibles are not limited to the items specifically

listed but also include "[o]ther" assets that similarly derive their value from their "intangible properties."[3] § 1.482-4(b)(1)-(6).

2. Valuing intangibles

Ensuring that multinationals pay an arm's-length amount for intangibles they create in the United States (often with substantial tax benefits) and then transfer to foreign affiliates is an ongoing problem for tax enforcement. For many years, the arm's-length price for intangible transfers was determined almost exclusively by reference to actual transfers between unrelated parties purportedly involving "the same or similar intangible property under the same or similar circumstances." 33 Fed. Reg. 5848, 5853 (1968). By the mid-1980s, however, Congress had become concerned that this approach (which depended on identifying comparable transactions) was undervaluing intangible transfers. Joint Committee on Tax'n, *Gen'l Explanation of the Tax Reform Act of 1986*, JCS-10-87, at 1014-1016 (1987).

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[3] Congress recently codified a similar definition out of concern that the Tax Court has not identified and valued all intangibles transferred between related parties. *See* Tax Cuts and Jobs Act of 2017, Pub. L. 115-97, § 14221(a)(2); H.R. Rep. No. 115-466, at 661 & n.1552 (2017) (Conf. Rep.).

In particular, and as relevant to this case, Congress was concerned about U.S. taxpayers "transferring relatively high profit intangibles" to foreign affiliates operating "in a low tax jurisdiction" without requiring the foreign affiliate to pay the U.S. taxpayer a price that was "commensurate with the income attributable to the intangible." H.R. Rep. No. 99-426, at 423, 425 (1985). To remedy this problem, and prevent U.S.-created intangibles from migrating to foreign affiliates for less than an arm's-length amount, Congress added the following sentence to Section 482 in 1986:

> In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Tax Reform Act of 1986, P.L. 99-514, § 1231(e)(1) (codified at I.R.C. § 482). The stated "objective" of the 1986 amendment – known as the commensurate-with-income requirement – was to ensure "that the division of income between related parties reasonably reflect the relative economic activity undertaken by each." H.R. Rep. No. 99-841, at II-637 (1986) (Conf. Rep.). Congress also directed Treasury to evaluate its transfer-pricing regulations and consider "whether [they] could be modified in any respect." *Id.* at II-638.

In response, Treasury overhauled its Section 482 regulations, promulgating final transfer-pricing regulations in 1994 (§§ 1.482-1 through 1.482-6, 1.482-8) and final cost-sharing regulations in 1995 (§ 1.482-7), which are the regulations at issue here. To prevent taxpayers from undervaluing intangibles, the 1994 regulations heightened the comparability standards for reliance on purportedly comparable transactions between unrelated parties, referred to as the comparable-uncontrolled-transaction (CUT) method, § 1.482-4(c). The 1994 regulations also provided alternative methods that, in many instances, could more reliably provide an arm's-length price for unique intangible transfers, including (as relevant to this case) "unspecified methods" described in § 1.482-4(d). The regulations require that the "best method" – the method providing the most reliable arm's-length result – be utilized. § 1.482-1(c).

Unlike the CUT method, an unspecified method does not depend on identifying a comparable uncontrolled transaction, which may not exist for any particular intangible or bundle of intangibles. To the contrary, the regulation addressing unspecified methods contemplates that such a method should take into account the economic benefits the

transferor could have realized had it not transferred the intangible at all. *See* § 1.482-4(d)(1). This approach reflects the "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." *Id.* For example, if the U.S. owner of an intangible could have reasonably expected to receive $4 billion (net present value) in future cash flows had it exploited the intangible itself in a foreign market, then it would not have licensed that intangible to an uncontrolled party for anything less than $4 billion, which would represent the minimum arm's-length consideration (net present value) for its license of the intangible to a foreign subsidiary.

3. Qualified-cost-sharing arrangements

The transfer of intangibles in this case arose in the context of a cost-sharing arrangement. Under a qualified-cost-sharing arrangement, related parties (typically a U.S. parent and its foreign subsidiary) agree to share intangible-development costs in proportion to their shares of reasonably anticipated benefits from exploiting any resulting intangible assets in their assigned areas (*e.g.*, North America

for the U.S. parent; Europe for the foreign subsidiary). *See* § 1.482-7A(a)(1).[4] Such arrangements provide taxpayers transfer-pricing certainty because new intangibles need not be valued as they are developed by the parent and licensed to the subsidiary; rather, all cost-sharing participants are considered co-owners of the new intangibles. Because the U.S. parent typically incurs the lion's share of the costs, the foreign subsidiary ends up making a cost-sharing payment to the U.S. parent each year, which increases the U.S. parent's taxable income.

Intangible-development activities that are cost-shared on a going-forward basis typically do not start from scratch; rather, such activities usually benefit from, and build upon, the U.S. parent's existing intangibles. Attempts by cost-sharing participants to utilize these "head-start" pre-existing intangibles without paying arm's-length consideration has been an ongoing challenge for tax enforcement.

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[4] The cost-sharing regulations at issue in this case (the 1995 regulations) were revised by Treasury in 2009 (temporary regulations) and 2011 (final regulations) to provide more detailed guidance regarding cost-sharing arrangements. *See* 74 Fed. Reg. 340 (2009); 76 Fed. Reg. 80082 (2011). In 2009, the version of the 1995 regulations applicable to the years at issue here (2005-2006) was redesignated as § 1.482-7A. Hereafter, we refer to the 1995 regulations by their redesignation (§ 1.482-7A).

Congress highlighted that problem in 1986 when it amended Section 482 to combat multinationals' abuses regarding intangible-property transfers. H.R. Rep. No. 99-841, at II-638. As Congress explained, if "one party [to a cost-sharing arrangement] is actually contributing funds toward research and development at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be required to such party to reflect its investment." *Id.*

Treasury addressed Congress's concern when it promulgated the 1995 regulations by enacting an explicit buy-in requirement for pre-existing intangibles made available for use in cost-sharing arrangements. Pursuant to these regulations, a foreign subsidiary must pay an "arm's length charge" for the intangibles that its U.S. parent "made available" in the cost-sharing arrangement "for purposes of research in the intangible development area." § 1.482-7A(g)(2). To determine the amount of that buy-in payment, the 1995 regulations incorporate by reference the definition of intangibles (§ 1.482-4(b)) and the methods for valuing intangibles (§§ 1.482-4 through 1.482-6)

provided in the 1994 regulations. § 1.482-7A(a)(2), (g). The buy-in payment also must satisfy the general rules applicable to all transfer pricing (§ 1.482-1), in particular the arm's-length standard. § 1.482-7A(g)(1) (cross-referencing § 1.482-1).

A buy-in payment is required for pre-existing intangibles used in the development of subsequent intangibles, even if the pre-existing intangibles are not formally transferred to the foreign affiliate. If the U.S. parent "makes" intangible property "available" for use in subsequent development, it "will be treated as having transferred" those intangibles, and the foreign subsidiary "must make a buy-in payment" as consideration for the use thereof. § 1.482-7A(g)(1), (2). The buy-in payment can be made in the form of a lump-sum payment, installment payments, or royalties, so long as it results in an "arm's length charge." § 1.482-7A(g)(2)&(7).

C. Amazon

Amazon.com and its U.S. and foreign subsidiaries (collectively Amazon) operate the world's leading online retail business. (ER409.) Amazon began operations in the United States in 1995 and expanded into Europe in 1998. (Op/ER10-13.) During the tax years at issue

(2005-2006), Amazon's European operations (European Business) were limited to the UK, Germany, and France. (Op/ER13.)

From 1999-2005, Amazon-US was the inventory owner and seller of record with respect to Amazon's European Business, which rendered the associated profits/losses reportable on Amazon-US's U.S. income tax return. (Op/ER16-17.) Amazon subsidiaries organized in the UK, Germany, and France (collectively the European Subsidiaries) provided support services to Amazon-US in connection with its European Business. (Op/ER16-17; ER959-961.)

By 2004, Amazon's European Business accounted for one third of its worldwide revenues, with 23-30% annual growth expected from 2005-2011. (ER395, 413.) The key to this expected success was the bundle of intangibles that Amazon-US created during the first decade of its existence. (Op/ER18; ER255-258, 321-329, 657.) Those intangibles included licensable items such as technology and trademarks and – importantly – items traditionally considered inseparable from the business itself such as corporate culture and workforce-in-place. Perhaps the most valuable item in this latter category was Amazon-US's culture of continuous innovation. (Op/ER24, 29.) This corporate

culture, which set Amazon apart from other companies, fell under the rubric of what the parties referred to as "growth options." (ER684-687, 700-714, 749-752, 782.) To develop its bundle of intangibles, Amazon-US spent almost $1.5 billion during its first decade (1995-2004). (ER334.)

D. Amazon's IP Migration Project

In the early 2000s, Amazon decided to restructure the ownership of its European Business by transferring it from Amazon-US to a group of newly formed Luxembourg subsidiaries (collectively Amazon-LUX). (Op/ER20-26; ER219, 225-251.) The restructuring was described as the "IP Migration Project" (later renamed Project Goldcrest) because all of the intangibles that Amazon-US had created to operate the business were transferred, or made available, to Amazon-LUX. (ER669-670, 863-928.)

Because Amazon-US generally was not subject to U.S. federal income tax on foreign income earned by its foreign affiliates (unless that income is repatriated to Amazon-US as a dividend), Amazon expected to significantly lower its worldwide corporate income tax by transferring its European Business to Amazon-LUX. (Op/ER20; ER330-332, 664-

666.) Amazon projected that, by implementing the IP Migration Project, it would avoid more than $1 billion in U.S. tax during 2005-2010 alone, with more tax savings expected in subsequent years. (ER656-660, 929-938, 942-943.) In addition, by utilizing a holding company structure with respect to Amazon-LUX – pursuant to which Amazon-US would license the intangibles to the Luxembourg holding company, which would then sub-license the intangibles to the Luxembourg operating company beneath it – Amazon expected to avoid Luxembourg taxation on most of Amazon-LUX's income. (ER252B-252E, 654-655, 661-662, 957-958.) Before implementing the IP Migration Project, Amazon worked out a deal with the Luxembourg taxing authorities whereby they agreed that the royalty payable by the operating company to the holding company would be an amount sufficient to "soak up" almost all of the operating company's income that would otherwise be subject to Luxembourg tax. (*Id.*) Because the holding company – although treated as a corporation for U.S. tax purposes and therefore not subject to U.S. tax – was treated as a partnership with U.S. partners for Luxembourg tax purposes, the royalty it received from the operating company would not be subject to

Luxembourg tax. (ER223, 252B-252E, 330-332, 642-657, 661-663, 957-958.)

Amazon implemented the IP Migration Project through a series of integrated transactions in 2005-2006. (Op/ER22; ER219, 225-251, 863-928.)

- In January 2005, Amazon-US entered into a Cost-Sharing Agreement with Amazon-LUX. (ER259-282.) Through that arrangement, Amazon-LUX would benefit from the full panoply of pre-existing intangibles that Amazon-US brought to bear on the development of subsequent intangibles. (ER684-686, 704-705.) In exchange for its future cost-sharing payments (and a buy-in payment with respect to the pre-existing intangibles), Amazon-LUX obtained the right to exploit any resulting intangible assets in Europe.
- At the same time, Amazon-US and Amazon-LUX entered into a License Agreement whereby Amazon-US licensed its existing technology-related intangibles to Amazon-LUX. (ER283-295.) In exchange, Amazon-LUX agreed to pay $226

million for the use of these intangibles in seven annual installments beginning in 2005. (ER220-222.)

- In July 2005, Amazon-US and Amazon-LUX entered into an Assignment Agreement whereby Amazon-US assigned to Amazon-LUX customer data and certain marketing intangibles (including trademarks, website content, and domain names) relating to the European Business. (ER296-320.) In exchange, Amazon-LUX agreed to pay $28 million for these intangibles in six annual installments beginning in 2006. (ER221-222.)
- In February 2006, Amazon.com transferred the stock of the European Subsidiaries to Amazon-LUX in exchange for consideration worth $196 million. (Op/ER25.) After the transfer, the European Subsidiaries provided Amazon-LUX the same support services in connection with the European Business that they previously had provided Amazon-US. (Op/ER17, 26.)
- In April-May 2006, Amazon-US effected the transfer of the remaining assets related to its European Business (including

the inventory) to Amazon-LUX in exchange for consideration worth $200 million. (Op/ER25-26; ER253.)

- At the same time, the European Subsidiaries assigned to Amazon-LUX certain marketing intangibles that they owned (the "European Portfolio") for $5 million. (Op/ER26, 154; ER609-612.)

E. Amazon-LUX's buy-in payment

Amazon intended the Cost-Sharing Agreement to be a "qualified cost sharing agreement" within the meaning of § 1.482-7A(a)(1). (ER259.) If it qualified, Amazon-LUX would be able to obtain partial ownership of intangibles subsequently developed by Amazon-US in exchange for paying its share of subsequently incurred intangible-development costs. (Op/ER23.) To qualify for this arrangement, however, Amazon-LUX was required to pay Amazon-US for its pre-existing intangibles made available for developing the subsequent intangibles (a payment that would increase Amazon-US's income for tax purposes). (Op/ER69 (citing § 1.482-7A(g)); ER640-641.)

To compute the buy-in payment, Amazon-US relied on a transfer-pricing study performed by Deloitte LLP. (Op/ER51-52; ER641.)

Deloitte concluded that an income-based unspecified method contemplated in § 1.482-4(d) was the most reliable measure of an arm's-length price for the intangibles. (Op/ER52; ER683.) Applying that method, Deloitte first computed Amazon-LUX's expected profit for 2005-2011, relying on Amazon-US's profit projections for the European Business, and then allocated a portion of that profit to the pre-existing intangibles. (Op/ER53.) Deloitte limited its profit analysis to 2005-2011 because it assumed that the pre-existing intangibles would contribute to Amazon-LUX's profits for only 7 years. (Op/ER7, 53; ER356-370, 746-748.) Deloitte concluded that the pre-existing intangibles were worth $217 million, a buy-in amount representing the present value of the installment payments due from Amazon-LUX under the License Agreement ($226 million) and Assignment Agreement ($28 million). (Op/ER53; ER222.)

The Commissioner rejected Amazon-US's buy-in calculation, determining that it grossly undervalued the bundle of intangibles that Amazon-US made available to Amazon-LUX in conjunction with the parties' cost-sharing arrangement. (Op/ER7.) Amazon-US then sought review of that determination in the Tax Court.

F. Tax Court proceedings

During the Tax Court proceedings, the parties disputed which of the regulatory methods for valuing intangibles provided for in § 1.482-4 was the best method for determining an arm's-length price for the bundle of intangibles that Amazon-US made available to Amazon-LUX: an income-based unspecified method (as the Commissioner argued) or the CUT method (as Amazon-US argued).[5] That dispute was predicated, in significant part, on the parties' interpretation of the regulatory definition of intangibles set out in § 1.482-4(b) and incorporated by reference in § 1.482-7A(a)(2).

1. The Commissioner's transfer-pricing method (DCF)

The Commissioner determined that an unspecified method – the discounted-cash-flow method (DCF) – was the best method for valuing the bundle of intangibles that Amazon-US made available to the cost-sharing arrangement. (ER373-374, 453-456.)

The DCF is commonly used by economists and businesses (including Amazon itself) to value intangibles, and is based on the

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[5] In the Tax Court proceedings, Amazon-US abandoned Deloitte's income-based unspecified method.

principle that an asset's current value is equal to the present value of the net cash flows that it is expected to generate in the future. (ER456, 542-543, 772-777, 955-956.) Because future cash flows are subject to risk, the DCF discounts the estimated future cash flows to a present value using a discount rate that reflects not only the time value of money, but also the riskiness of the assets – the higher the risk, the higher the discount rate, and the lower the present value. (ER380-381, 772.) The appropriate discount rate is the rate of return that market participants would require for similar investments, that is, their cost of capital. (ER560, 695-700.) As long as one has access to reliable projections of expected future cash flows and the associated cost of capital, the DCF is viewed as an accurate estimate of value. (ER544.) In this case, the Commissioner's expert (Frisch) had access to Amazon's own revenue projections for the European Business, as well as Amazon's weighted average cost of capital. (ER468-473, 718-720.) The goal was to establish the expected cash flows of the European Business and then determine the portion thereof attributable to Amazon-US's pre-existing intangibles.

Frisch began by projecting Amazon-LUX's cash flows for 20 years (2005-2024) and calculating a terminal value[6] to account for subsequent cash flows. (ER718-719, 953.) For 2005-2011, Frisch utilized Amazon management's projections that the European Business would experience 23-30% annual growth; for 2012-2024, he assumed only 3.8% annual growth. (ER374-378, 721-722.)

Frisch made several adjustments to the European Business's projected cash flows to isolate the cash flows attributable to Amazon-US's pre-existing intangibles. First, he subtracted Amazon-LUX's contributions to the business, including its tangible assets, its projected cost-sharing payments to Amazon-US, and the contributions of the European Subsidiaries (which, after the restructuring, were owned by Amazon-LUX). (ER468-469, 724-725, 735-736.) He then applied an 18% discount rate to the remaining net cash flows to compute the present value of the pre-existing intangibles. (ER473-474.) Frisch

[6] Economists and businesses use terminal-value calculations in conjunction with the DCF where one or more of the assets to be valued has an indefinite useful life. (ER358-360, 671-672, 707, 718-719.) Although Frisch identified Amazon-US's trademarks and domain names as assets with indefinite useful lives (ER358, 443), the same principle applies to enterprise-related intangibles that retain value as long as the business is a going concern.

explained that, after adjusting the cash flows to account for Amazon-LUX's contributions, the remaining projected cash flows are necessarily attributable to Amazon-US's pre-existing intangibles. (ER457-465, 474-475.)

Frisch's largest adjustment related to the cost-sharing payments that management projected Amazon-LUX would make in the future. (ER708.) This adjustment was designed to ensure that Amazon-LUX did not pay twice for the subsequently developed intangibles (that is, once through the cost-sharing payments and once through the buy-in payment). (ER725-727, 730.) The adjustment had the effect (for purposes of computing the buy-in payment) of giving Amazon-LUX a projected 18% return on its projected cost-sharing payments. (ER708.) The projected 18% return was the market rate of return that an unrelated party would have expected to earn on its cost-sharing payments had it entered into a cost-sharing arrangement with Amazon-US under the same circumstances as those presented here. (ER380-381, 573-578, 723, 737-740.) But, as Frisch emphasized, his DCF did not cap Amazon-LUX's returns at 18%; under his model, any actual

returns that exceeded projected returns would redound entirely to Amazon-LUX's benefit. (ER740-744, 759-763.)

Frisch concluded that an unrelated party in Amazon-LUX's position would have been willing to make a buy-in payment of $2.9 billion.[7] (ER381-384, 953.) The bulk of that amount ($2.6 billion) was the value that the pre-existing intangibles added to the European Business during the first 20 years; the remaining $300 million was their terminal value. (ER953.)

The Commissioner argued that Frisch's DCF analysis was supported by the realistic-alternatives principle set forth in the transfer-pricing regulations, §§ 1.482-1(f)(2)(ii), 1.482-4(d)(1). As Frisch explained, $2.9 billion was the present value of the cash flows that Amazon-US would have expected its pre-existing intangibles to generate in the European Business over time had it opted for its

[7] Frisch calculated a range of values for the pre-existing intangibles ($2.9-$3.4 billion), depending on the amount of projected cost-sharing payments included in the computation. (ER381-383, 731-734, 953.) The parties agree that if the projected cost-sharing payments as calculated by another expert (Higinbotham) were used in Frisch's DCF analysis, the resulting buy-in payment would be $2.9 billion. (Op/ER88 n.22; ER953.) Because the Tax Court endorsed Higinbotham's calculation (with minor adjustments) (Op/ER178-185), we utilize Frisch's $2.9 billion figure.

realistic alternative of not entering into the cost-sharing arrangement and continuing to operate the European Business as it had before. (ER363-370, 433, 953.)

Amazon-US argued that the Commissioner's DCF method was foreclosed as a matter of law because it "includes in the buy-in substantial value attributable to residual values that are not compensable." (ER801.) In particular, Amazon-US argued that "growth options" are "non-compensable" intangibles under § 1.482-4(b). (ER796, 801-803.) Amazon-US's expert (Cornell) acknowledged that "Amazon's significant growth options (*i.e.*, its unique business attributes and expectancies)" (ER340-341) were immensely valuable intangibles that parties dealing at arm's length would have paid for (ER685-686). He nevertheless opined that Frisch's DCF valuation was not the best method because – based on instructions from Amazon-US's counsel (ER688-690) – he understood that growth options "were not subject to a buy-in payment" under the regulations (ER340-341) but could instead be transferred "for free" (ER693).[8]

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[8] In the Tax Court, the Commissioner argued that Frisch's DCF valuation was conservative because it did not include the value of the

2. Amazon-US's transfer-pricing method (CUT)

Amazon-US argued that the best method for valuing the specific intangibles that it agreed were compensable – technology intangibles, marketing intangibles, and customer information – was the CUT method. (Op/ER89.) The CUT method determines an arm's-length price for a controlled transaction by reference to the price in a comparable uncontrolled transaction. § 1.482-4(c)(1). The experts were unable to locate a comparable transaction that involved the full bundle of intangibles. (ER691-692, 753-754, 771.) Instead, they determined a buy-in price for the website technology, marketing intangibles, and European customer information as if they had been transferred separately. (Op/ER89-90.) Amazon-US's CUT analysis resulted in a buy-in payment of $350 million. (ER798.)

The Commissioner's experts applied an alternative CUT method (in support of his primary DCF method) to value the same discrete set of intangibles and concluded that Amazon-US's CUT analysis grossly undervalued those intangibles. (Op/ER90-173.) In particular, the

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growth options. (ER805-806.) The Tax Court disagreed. On appeal, we accept the court's finding that Frisch's valuation includes the value of Amazon-US's substantial pre-existing growth options. (Op/ER82.)

Commissioner argued that Amazon-US's analysis incorrectly limited the value of the three sets of intangibles on the basis of their purported useful lives and decay rates. (ER807, 816-817.) That limitation, the Commissioner contended, disregarded the role that the pre-existing intangibles played in the development of future intangibles – a significant value-driver that (in the Commissioner's view) was part of § 1.482-7A(g)'s buy-in requirement. (ER572-578, 783-785.)

3. Tax Court's opinion

The Tax Court determined that neither party's transfer-pricing analysis was reasonable. (Op/ER89-90.) The court first addressed the Commissioner's DCF method. (Op/ER73-88.) It accepted Frisch's primary inputs, finding (i) that the 18% discount rate utilized by Frisch was "appropriate" (Op/ER126), and (ii) that Frisch's projections that the "revenue, expenses, and operating income of the European business would grow at 3.8% per year" after 2011 was "conservative and reasonable" (Op/ER74 & n.15). The court nevertheless agreed with Amazon-US that the Commissioner's DCF method was foreclosed by the regulations. (Op/ER88 & n.22.) The court identified two legal reasons

why (in its view) the Commissioner had abused his discretion in using the DCF method to calculate the buy-in payment.

First, the Tax Court found that the DCF's "enterprise valuation of a business includes many items of value that are not 'intangibles' as defined [in § 1.482-4(b)]. These include workforce in place, going concern value, goodwill, and what trial witnesses described as 'growth options' and corporate 'resources' or 'opportunities.'" (Op/ER79.) The court determined that such "residual business assets" do "not constitute 'pre-existing intangible property' under the cost-sharing regulations in effect during 2005-2006." (Op/ER82.) The court did not address whether a company entering into a cost-sharing arrangement with an unrelated party would make these "items of value" available to the other party without any charge. (Op/ER73-88.)

Second, the Tax Court determined that the DCF method "improperly aggregates pre-existing intangibles (which are subject to the buy-in payment) and subsequently developed intangibles (which are not)" by calculating the value of the pre-existing intangibles by reference (in part) to future cash flows associated with subsequently developed intangibles. (Op/ER82.) The court rejected the

Commissioner's argument that this approach was necessitated by § 1.482-7A(g)(2), which requires arm's-length consideration for the use of pre-existing intangibles "for purposes of research in the intangible development area." (Op/ER87-88.) The court also rejected the Commissioner's reliance on the realistic-alternatives principle, holding that his analysis conflicted with the regulations. (Op/ER83-84.)

The Tax Court next addressed the CUT method. The court agreed with Amazon-US that it was the best method because it was limited to the three categories of intangibles that the court determined were compensable under the regulations. (Op/ER89-90.) The court, however, rejected both parties' CUT analyses. (Op/ER89-173.) The court's CUT analysis resulted in a buy-in payment of $779 million.[9] (ER217.)

SUMMARY OF ARGUMENT

This case involves a multinational company (Amazon) that shifted a substantial amount of its income from its U.S. consolidated group

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[9] The Tax Court also addressed the parties' disputes regarding (i) whether Amazon-US or the European Subsidiaries owned (and therefore transferred to Amazon-LUX) the European Portfolio of marketing intangibles, and (ii) the scope of Amazon-US's intangible-development costs that were subject to reimbursement by Amazon-LUX under the cost-sharing arrangement. *See* Op/ER148-153, 173-185. The Government has not appealed these issues.

(Amazon-US) to its foreign affiliate (Amazon-LUX) in a manner that did not clearly reflect Amazon-US's true income. That income-shifting resulted from an artificially low buy-in payment that Amazon-US charged for the extraordinarily valuable pre-existing intangibles it made available to Amazon-LUX in conjunction with a cost-sharing arrangement.

Section 482 and its implementing regulations require that participants in a cost-sharing arrangement pay arm's-length consideration for the use of pre-existing intangibles that other participants make available to the arrangement. Applying those regulations, the Commissioner determined that the best method to calculate the mandatory arm's-length charge was the discounted-cash-flow (DCF) method, a method commonly used to value intangibles. It further determined that Amazon-US had undervalued its pre-existing intangibles by $2.7 billion. The Tax Court disagreed, holding that the Commissioner's DCF method violates the relevant Treasury regulations because it (i) includes intangibles that were not (in the court's view) compensable under those regulations and (ii) values the pre-existing

intangibles in part by reference to future cash flows associated with subsequently developed intangibles.

1. The Tax Court erred as a matter of law in failing to require Amazon-LUX to compensate Amazon-US for the valuable growth options and other residual-business assets it made available to the cost-sharing arrangement. The Treasury regulations broadly define intangibles and do not exclude residual-business assets from the scope of the buy-in requirement. The court's narrow interpretation of the regulations is supported by neither their language nor their history. Moreover, that interpretation would allow U.S. corporations to provide access to intangibles worth billions of dollars to offshore affiliates for free, even though it is undisputed that parties dealing at arm's length would have required payment. Because this interpretation would "stultify" Section 482's "purpose" – which is "to ensure that taxpayers clearly reflect income attributable to controlled transactions," § 1.482-1(a)(1) – it should be rejected. *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191, 1195-1196 (9th Cir. 2010).

2. The Tax Court further erred as a matter of law in holding that the regulations prohibit the Commissioner from determining the arm's-

length buy-in payment by reference (in part) to projected cash flows associated with future intangibles the parties anticipate will result from the cost-sharing arrangement. The court's holding in that regard fails to acknowledge that Amazon-US's pre-existing intangibles – as well as the parties' intangible-development expenditures – contributed to the development of new intangibles under the arrangement. And Treasury regulations require that arm's-length consideration be paid for that contribution to value. The court's contrary determination – that such value could be transferred for free – runs counter to the *raison d'être* of Section 482 and the regulations thereunder.

3. Because the Commissioner's DCF method accounts for the full value of all the pre-existing intangibles – as defined in § 1.482-4(b) – that Amazon-US made available to the cost-sharing arrangement, he could not have abused his discretion in selecting that method to determine the arm's-length buy-in payment. Moreover, the Tax Court's CUT analysis necessarily is unreasonable because it indisputably did not include the value of Amazon-US's residual-business intangibles. This Court should therefore vacate the Tax Court's decision and remand

the case for a proper application of the Commissioner's DCF method to the facts of this case.

ARGUMENT

The Tax Court wrongly concluded that the method utilized by the Commissioner to determine an arm's-length price for the intangibles at issue violates Section 482's implementing regulations

Standard of review

This case concerns whether Section 482 and the related regulations require Amazon-LUX to compensate Amazon-US (i) for all of the valuable intangibles Amazon-US made available to the parties' cost-sharing arrangement, including those that may not be separable from the business itself ("residual-business assets"), and (ii) for the full value of the use of those intangibles in conjunction with that arrangement. Those issues raise legal questions, which are reviewed "de novo." *DHL Corp. v. Commissioner*, 285 F.3d 1210, 1216 (9th Cir. 2002). The Commissioner raised these issues during the Tax Court proceedings. *E.g.*, ER808-830.

A. Introduction

"Section 482 gives the Commissioner broad discretion to place controlled taxpayers in the same position as uncontrolled taxpayers

dealing at arms-length." *Peck v. Commissioner*, 752 F.2d 469, 472 (9th Cir. 1985). The Commissioner's broad discretion is particularly important in the context of U.S.-based multinational companies, given their ability to erode the U.S. tax base by transferring or licensing income-producing property to foreign affiliates operating in low-tax jurisdictions through pricing that does not reflect an arm's-length result. *See* Jane Gravelle, *Tax Havens: International Tax Avoidance & Evasion*, Cong. Research Serv. No. R40623 at 1 (2015) (estimating U.S. revenue loss from "corporate profit shifting" as $10-90 billion per year). The problem is most acute with regard to intangibles, the valuation of which is easily manipulated by taxpayers. *Id*. at 12; *see* Franklin Foer, *World Without Mind: The Existential Threat of Big Tech* 196-197 (2017) (observing how in "Project Goldcrest," Amazon "drastically understated the value of the assets it shifted to Luxembourg"); Harry Davies, *Revealed: How Project Goldcrest Helped Amazon Avoid Huge Sums in Tax*, Guardian, Feb. 18, 2016 (observing how "technology giants minimise their tax bills by shifting valuable – but difficult to value – intellectual property into offshore havens"); Simon Marks, *Amazon: How the World's Largest Retailer Keeps Tax Collectors at Bay*,

Newsweek, July 13, 2016 (describing how Amazon "undervalue[d]" the intangibles transferred in "Project Goldcrest" for U.S.-tax purposes and, at the same time, "inflated" their value for Luxembourg-tax purposes in order to avoid tax in both jurisdictions); ER330-332, 642-663, 929-938, 957-958.

As detailed above, since 1986, Congress and Treasury have taken steps to prevent such manipulations. *See* Statement of the Case § B. The regulations at issue in this appeal – the 1994 (§§ 1.482-1, 1.482-4) and 1995 (§ 1.482-7A) transfer-pricing regulations – implement Congress's reform initiative.

The Tax Court's decision thwarts these remedial efforts. The court's rejection of the Commissioner's DCF method, and its reliance on the CUT method to value only part of the bundle of intangibles that Amazon-US made available to Amazon-LUX in conjunction with the cost-sharing arrangement, violate the 1994 and 1995 regulations. Those regulations require Amazon-LUX to compensate Amazon-US (i) for *all* pre-existing intangibles made available to Amazon-LUX, including Amazon-US's growth options, *see*, below, § C, and (ii) for the

full value of the use of those pre-existing intangibles in the context of the cost-sharing arrangement, *see*, below, § D.

In reaching a contrary conclusion, the Tax Court not only misinterpreted the regulations, but also failed to construe them in light of their "purpose," in contradiction to binding precedent. *Xilinx*, 598 F.3d at 1195-1196. The purpose of the Section 482 regulations is "to ensure that taxpayers clearly reflect income attributable to controlled transactions." § 1.482-1(a)(1). Although Amazon-US took the position that the regulations permitted it to provide its foreign subsidiary free access to valuable intangibles (ER693), parties dealing at arm's length generally do not transfer valuable property for free. *See Likins-Foster Honolulu Corp. v. Commissioner*, 840 F.2d 642, 647 (9th Cir. 1988) (holding that "unrelated parties dealing at arm's length would not customarily loan large sums without interest"). In this case, the record establishes that a company dealing at arm's length would have required compensation for the full value of the pre-existing intangibles, including residual-business assets. *See*, below, § B.

B. It is undisputed that a company dealing at arm's length would have required compensation for all of the intangibles Amazon-US made available to the cost-sharing arrangement, including residual-business assets

We begin with the foundational principle that applies in every transfer-pricing case: if a company dealing at arm's length would have charged for the full value of the intangibles Amazon-US made available to the cost-sharing arrangement, then Amazon-LUX is required to pay that amount as well.[10] The Tax Court was not free to disregard this principle; it is mandatory and applies "'in every case.'" *Xilinx*, 598 F.3d at 1196 (quoting § 1.482-1(b)(1)).

Both parties' experts agreed that an uncontrolled party would pay for access to Amazon-US's valuable residual-business assets, including

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[10] We use the phrase "dealing at arm's length" in the regulatory sense of "the results that *would have been* realized if uncontrolled taxpayers *had engaged* in the *same* transaction under the *same* circumstances." § 1.482-1(b)(1) (emphasis added). In *Altera v. Commissioner* (9th Cir. Nos. 16-70496, 16-70497), the Government has taken the position that Treasury had the authority to preemptively make that (ultimately) hypothetical determination by regulation in the limited context of cost-sharing, *i.e.*, by conditioning arm's-length status on the sharing of all R&D-related costs in proportion to reasonably anticipated benefits. *See* § 1.482-7A(a)(3). As explained in our *Altera* briefs, that position is entirely consistent with the articulation of the arm's-length standard in § 1.482-1(b)(1) (and therefore with our discussion of the arm's-length standard in this brief).

its significant growth options resulting from its culture of relentless innovation. (ER340, 578-581, 684-686, 700-703, 780-781.) As Amazon-US's expert (Cornell) acknowledged, parties dealing at arm's length "[d]efinitely" pay for "growth options" (ER686) because "[n]o company is going to give away something of value without compensation" (ER703). He explained that he excluded them from his valuation analysis only because he was informed by Amazon-US's counsel that the regulations permitted Amazon-US to provide Amazon-LUX access to them "for free." (ER693.) He conceded that if growth options were compensable intangibles under the regulations, it would "change the legal conclusion in this case." (ER716.)

Indeed, Cornell agreed that if "all" of the valuable intangibles were compensable, he would compute their value exactly as Frisch did – he would "value the entire business and take out the tangibles." (ER716-717.) But, because Frisch's valuation "includes substantial value attributable to Amazon-US's significant growth options (*i.e.*, its unique business attributes and expectancies)" that Cornell understood from Amazon-US's counsel could be transferred "for free" and "were not

subject to a buy-in payment under the applicable tax regulations" (ER340, 693), his ultimate analysis diverged from Frisch's valuation.

As demonstrated below, neither the 1994 nor the 1995 transfer-pricing regulations exempt any specific intangible from the scope of Section 482. If a company entering into the same transaction under the same circumstances with an unrelated party would have included the value of a particular intangible in the buy-in payment, then – by definition – the buy-in payment here would have to include the value of that intangible in order to achieve an arm's-length result. Any other interpretation of the regulations would "stultify [their] purpose" and should be rejected. *Xilinx*, 598 F.3d at 1196.

C. The Tax Court's determination that Amazon-LUX need not compensate Amazon-US for all of the pre-existing intangibles, including residual-business assets, is wrong as a matter of law

As noted above, the Tax Court failed to address whether a company dealing at arm's length would have required compensation for Amazon-US's valuable residual-business assets, including its growth options. Instead, the court simply concluded that the buy-in payment need not provide such compensation because (in its view) such assets "were not compensable 'intangibles' to begin with" under the 1994

regulations. (Op/ER78-79.) That conclusion conflicts with § 1.482-4(b)'s broad definition of intangibles, other aspects of the regulatory scheme (including § 1.482-1's arm's-length standard), and the regulation's history.

1. The Tax Court's determination that residual-business assets like growth options are not compensable intangibles conflicts with a plain reading of § 1.482-4(b)

The Tax Court's interpretation of "intangibles" conflicts with the plain language of § 1.482-4(b). *See DHL*, 285 F.3d at 1221 (reversing Tax Court determination that conflicted with the "plain language" of the Section 482 regulations). Section 1.482-4(b) broadly defines intangibles and reads in its entirety as follows:

> (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.

By its terms, § 1.482-4(b) does not exclude any particular asset. Rather, an asset fits within § 1.482-4(b)'s definition of intangible if it (i) "has substantial value independent of the services of any individual" and (ii) comprises any of the items in the regulation's six described categories. The sixth category – the "similar items" category – is a catch-all provision that includes any asset that "derives its value" from "intangible properties" rather than "physical attributes." § 1.482-4(b)(6). Thus, under the plain language of the regulation, growth options are "intangibles" for purposes of § 1.482-4(b) (and thus for purposes of § 1.482-7A(g)'s buy-in requirement) if they derive their value from intangible, rather than physical, attributes, and have substantial value independent of the services of any individual.

Growth options satisfy both components of the regulatory definition of intangible. First, growth options – a concededly valuable

asset (Op/ER79) – derive their value from intangible, rather than physical, attributes. Amazon-US's expert (Cornell) described the intangible (but valuable) nature of growth options as primarily attributable to Amazon-US's culture of innovation:

> I see [growth options] as being embedded in the what I call "the culture" of the company. It's people and how they interrelate, and do you have a mechanism by which creative ideas can bubble up and be utilized or are you held down by a bureaucracy that doesn't allow creativity to flourish?
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> . . .
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> . . . [T]he corporate culture is so important. It's not just throwing money at something, it's having an organization in place that promotes and makes possible creative innovation. That in itself is such a valuable asset in my mind.
>
> . . . [W]hat really seems to set the Apples and the Amazons apart is that they have developed these unique innovative cultures that keep churning out new products. . . .

(ER704-705, 715.) Growth options, he concluded, are "rooted in the culture of the firm" and are "not totally separate" from Amazon-US's other intangibles. (ER712.)

Second, growth options' substantial value is independent of the services of any individual. (ER686-688, 712-713.) As indicated above, they are "part of the culture of Amazon to be able to have creative ideas bubble up in their organization and actually use them." (ER713.) The

value of that innovative culture is independent of the services of any one Amazon-US employee, and is interrelated with all of Amazon-US's pre-existing intangibles, including its "systems" and business "processes." (ER498, 575, 684-686, 780-781.)

We recognize that the Tax Court held to the contrary, asserting (without explanation) that residual-business assets (including growth options) "do not derive their value from their 'intellectual content or other intangible properties.'" (Op/ER80.) But that bald assertion is clearly wrong, given that growth options and other residual-business assets – which indisputably are not tangible assets – could *only* derive their value from their intangible properties. Indeed, Amazon-US's own expert acknowledged that a "broad definition of intangibles" would include "growth options." (ER338.)

Similarly misconceived is the Tax Court's rationale that residual-business assets (including growth options) are not compensable because, unlike items specifically listed in § 1.482-4(b), they "cannot be bought and sold independently; they are an inseparable component of an enterprise's residual business value." (Op/ER79-80.) The regulations, however, do not limit intangibles to those that can be

"bought and sold independently." That a valuable item cannot be bought and sold independently does not mean that it cannot be transferred as part of a bundle of intangibles or made available to a cost-sharing arrangement. The court's re-writing of the regulation to include such a limitation was legal error. *See DHL*, 285 F.3d at 1221.

Moreover, the Tax Court failed to appreciate the significant overlap between growth options and the specifically identified intangibles listed in § 1.482-4(b)(1)-(5). As the experts explained, growth options are created by pre-existing intangibles such as "systems and processes" and "everything that makes the business valuable" (ER686-687) and, as such, are "attached to the ownership of existing" intangibles (ER778-779, 782). Such "systems" and "processes" are intangibles specifically listed in § 1.482-4(b)(1) and (5). Section 1.482-4(b) defines intangibles to include property that "comprises" any of the specifically listed intangibles, which growth options – comprising, in part, Amazon-US's systems and processes (ER498, 686) – indisputably do.

Given that growth options fit comfortably within the scope of § 1.482-4(b)(6), and comprise intangibles specifically listed in § 1.482-

4(b)(1)-(5), the Tax Court erred as a matter of law in concluding that Amazon-US could provide Amazon-LUX access to its valuable growth options in connection with the cost-sharing arrangement "for free." (ER693.)

2. The Tax Court's interpretation of § 1.482-4(b) conflicts with the overall transfer-pricing regulatory scheme

Consideration of the overall regulatory scheme further supports an interpretation of § 1.482-4(b) that encompasses residual-business assets like growth options.

a. Section 1.482-7A

Section 1.482-4(b) must be read in conjunction with the cost-sharing regulations (§ 1.482-7A) that incorporate it by cross-reference. Section 1.482-7A does not exclude any item of intangible property from the buy-in requirement. To the contrary, the explicit "buy-in" requirement encompasses any intangible "made available" to the arrangement, § 1.482-7A(g)(2), and was added to the cost-sharing regulations to implement Congress's mandate that participants in the arrangement pay for such items. H.R. Rep. No. 99-841, at II-638.

The language of § 1.482-7A(g) also precludes the Tax Court's grafting an "independently transferrable" requirement onto § 1.482-4(b)'s definition of intangible (Op/ER79-80). In this regard, § 1.482-7A(g)(1) expressly provides that a party that "makes" intangible property "available to" a qualified-cost-sharing arrangement is "treated as having transferred" an interest in that property to the other participants in the arrangement. § 1.482-7A(g)(1). Thus, while it is true that residual-business assets generally cannot be transferred independently from the business enterprise with which they are associated, § 1.482-7A(g)(1) mandates that such assets be paid for even if they are made "available" to the cost-sharing participants without actually being transferred to them; the transfer is deemed to have occurred. The Tax Court's re-writing of § 1.482-4(b) cannot be squared with the express language of the cost-sharing regulations.

b. Section 1.482-1's arm's-length standard

Second, and most fundamentally, § 1.482-4(b) must be read in conjunction with § 1.482-1's arm's-length standard. Pursuant to that standard, if unrelated parties entering into the same transaction under the same circumstances would have accounted for intangibles like

growth options, then related parties must do so as well. That is the *raison d'être* of Section 482 and its implementing regulations. The regulations emphasize that the arm's-length standard applies in "every case." § 1.482-1(b)(1). Nothing in § 1.482-4(b) modifies or overrides this basic principle of transfer pricing.

This Court has held that the transfer-pricing regulations must be interpreted according to their "purpose," which is "to ensure that taxpayers clearly reflect income attributable to controlled transactions." § 1.482-1(a)(1); *see Xilinx*, 598 F.3d at 1195-1196. Any interpretation of a transfer-pricing regulation that is inconsistent with the arm's-length standard must be rejected, as this Court has emphasized: the "regulations are not to be construed to stultify th[eir] purpose." *Id*. at 1196.[11] By allowing Amazon-US to provide Amazon-LUX access to a valuable subset of its intangibles "for free" (ER693) when it is undisputed that a company entering into the same transaction under

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[11] In relying on *Xilinx*, we do not suggest that the plain language of § 1.482-4(b) excludes residual-business assets and that such regulation must nonetheless give way to § 1.482-1(b)(1). Rather, we contend that the plain language of § 1.482-4(b) *includes* residual-business assets, but that if there is any doubt in that regard, then such doubt should be resolved in favor of inclusion based on the dominant purpose of § 1.482-1(b)(1).

the same circumstances with an unrelated party would have required compensation, the Tax Court's narrowing interpretation of § 1.482-4(b) stultifies the regulations' purpose.

Ignoring this binding precedent, the Tax Court lost sight of the bigger picture. Under Section 482, *anything* of value that is made available between related parties must be paid for – *nothing* gets transferred for free (absent a regulatory safe harbor, of which there are none for buy-in payments). Taxpayers should not be permitted to conjure loopholes that simply do not exist. If § 1.482-4(b) were never promulgated, or was withdrawn tomorrow, that would not – and could not – imply that controlled taxpayers could transfer valuable assets "for free," whether defined as intangibles or otherwise.

3. The Tax Court's interpretation of § 1.482-4(b)'s definition of "intangibles" is not supported by the regulatory history

The Tax Court concluded that its narrow interpretation of § 1.482-4(b) was "supported by the regulations' history." (Op/ER80 n.18.) That is incorrect. The regulatory history supports the broadest definition of intangible property. To demonstrate the error in the court's conclusion, we provide some context for the 1994 regulations at issue here.

Section 482 itself originally did not define intangibles (by cross-reference or otherwise). The original Treasury regulations issued pursuant to Section 482 likewise did not define intangibles. Indeed, these regulations provided little guidance beyond the requirement that the "arm's length" standard be applied "in every case." 27 Fed. Reg. 3595, 3598 (1962). Under that governing standard, if a company entering into the same transaction under the same circumstances with an unrelated party would have paid for something of value – whether it be tangible, intangible, or in the form of services – then that company must pay for it as well in the related-party transaction.[12]

Specific guidance for applying the arm's-length standard to distinct transactions, such as transfers of money (loans), services, tangible property, and intangible property, was promulgated in 1968. 33 Fed. Reg. 5848. Pursuant to those regulations, a controlled party that "made available in any manner" any "intangible property" to another controlled party must receive "arm's length consideration" for

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[12] The original Treasury Regulations issued pursuant to Section 482's precursor (section 45 of the Revenue Act of 1934) are substantially the same as the 1962 regulations, and do not define (or even mention) intangibles. Treasury Regulations No. 86 at 122-124 (1935). There were no substantive revisions to the regulations from 1935 to 1962.

such property. *Id*. at 5852. The regulations broadly defined intangible property by reference to 27 specific types of intangible property (such as patents, brand names, methods, and programs) and "other similar items." *Id*. at 5854. The regulations did not limit the scope of "other similar items," so long as such "items have substantial value independent of the services of individual persons." *Id*. Importantly, no specific type of intangible was carved out from the regulations' requirement for arm's-length consideration.

Congress has long understood Treasury's definition of intangibles to be inclusive. In 1982, Congress adopted Treasury's definition of intangibles from the 1968 regulations when it amended Section 936 (which provides tax credits for corporations operating in Puerto Rico) to add a provision that addressed the tax treatment of intangible-property income (Section 936(h)). Tax Equity & Fiscal Responsibility Act of 1982, P.L. 97-248, § 213(a)(2). As enacted in 1982, Section 936(h) listed 28 specific types of intangible property[13] and a catch-all provision for "any similar item, which has substantial value independent of the

[13] Section 936(h) added "know-how" to the 27 examples of intangible property specifically listed in the 1968 Treasury regulations.

services of any individual." I.R.C. § 936(h)(3)(B)(i)-(vi). Reflecting the breadth of that definition, the legislative history emphasized that the amendment "defines intangible assets broadly." S. Rep. No. 97-494, at I-161 (1982). Like the 1968 transfer-pricing regulations, Section 936(h)(3)(B) contains no carve-out for particular types of intangible property.

Section 936(h)(3)(B)'s definition of intangibles was incorporated into Section 482 by cross-reference when Congress amended Section 482 in 1986 to add the commensurate-with-income requirement for intangibles. There is no indication in the legislative history to this anti-abuse amendment that Congress intended to narrow the scope of intangibles for transfer-pricing purposes. To the contrary, in that history, Congress directed that intangibles migrating to low-tax jurisdictions, or made available in a cost-sharing arrangement, be fully paid for to prevent erosion of the U.S. tax base. H.R. Rep. No. 99-841, at II-637-638.

In the early 1990's, and in response to Congress's directive, Treasury overhauled its transfer-pricing regulations, providing new methods for valuing intangibles as alternatives to the CUT method and

providing more guidance for cost-sharing arrangements. *See*, above, at pp. 9-13. As part of that overhaul, Treasury "clarified" its prior definition of intangibles by explaining the breadth of what § 1.482-4(b)(6)'s catch-all provision for "other similar items" includes. 59 Fed. Reg. 34971, 34983 (1994). The 1994 regulations define the category "other similar items" to mean "items that derive their value from intellectual content or other intangible properties rather than physical attributes." *Id.* Like the 1968 regulations, the 1994 regulations do not carve out any type of intangible from the scope of the definition.

The Tax Court relied on the regulatory history leading up to the 1994 regulations to support its interpretation of § 1.482-4(b) as excluding residual-business assets such as growth options and goodwill. (Op/ER80 n.18.) The court misreads the history. In this regard, the court cites the preamble to the temporary transfer-pricing regulations promulgated in 1993 in which the IRS requested comments "as to whether the definition of intangible property incorporated in § 1.482-4T(b) should be expanded to include items not normally considered to be items of intellectual property, such as work force in place, goodwill or

going concern value."[14] 58 Fed. Reg. 5310, 5312 (1993). The final regulations issued in 1994 did not expand the number of specifically named intangibles by adding goodwill, going concern, and workforce-in-place to the list; instead, the regulations clarified the catch-all provision in a way that would include those items. 59 Fed. Reg. at 34983. Pursuant to that clarification, which resolved any prior ambiguity, an applicable asset is a "similar" item, and therefore within the scope of § 1.482-4(b)'s intangibles, if it "derives its value not from its physical attributes but from its intellectual content or other intangible properties." § 1.482-4(b)(6).

Nothing in § 1.482-4(b)'s history suggests that growth options, goodwill, or any other intangible property that has substantial value independent of the services of any individual is exempt from Section 482's arm's-length requirements. Indeed, on the exact same day that the temporary regulations cited by the Tax Court (§ 1.482-4T) were promulgated (January 21, 1993), Treasury also issued proposed

[14] The definition in the temporary regulations was similar to the definition in Section 936(h)(3)(B), and included 28 specifically listed intangibles grouped into five categories, and a sixth, catch-all category for "[o]ther similar items." 58 Fed. Reg. 5263, 5287 (1993).

regulations implementing Section 6662(e)'s accuracy-related penalty for valuation misstatements attributable to Section 482 allocations, and those proposed regulations specifically identified "goodwill" as an example of "intangible property." 58 Fed. Reg. 5304, 5306 (1993). The following year, Treasury promulgated a temporary regulation, § 1.6662-5T(e)(3), that specified that "goodwill" was "intangible property" for purposes of Section 482 transactions. 59 Fed. Reg. 4791, 4795 (1994). This regulation – which was in effect when the final 1994 transfer-pricing regulations were promulgated – undermines the Tax Court's determination that Treasury viewed "goodwill" and other residual-business assets to be outside the scope of intangible property for purposes of Section 482.

The Tax Court is correct that the final 1994 transfer-pricing regulations do not expressly name goodwill, going concern, or workforce-in-place as intangibles, and therefore did not expand the *list* of specific intangibles set out in § 1.482-4(b)(1)-(5). Rather, the regulations obviated the need to continuously expand the list of specific intangibles by, instead, expanding the *definition* of "similar items" in a way that makes clear that it covers the full range of intangibles,

including intangibles that are not normally considered intellectual property. As relevant here, that clarification is broad enough to include growth options, which – like goodwill, going-concern value, workforce-in-place, and other residual-business assets – derive their value from intangible properties rather than physical attributes.

4. To the extent there is any doubt, the IRS's interpretation of its own regulations – recently endorsed by Congress – is conclusive

To the extent that there is any doubt regarding the breadth of the definition of intangibles set out in § 1.482-4(b), the Tax Court should have deferred to the IRS's interpretation of its own regulations. An agency's interpretation of its own regulations "must be given 'controlling weight'" if it is not "'plainly erroneous or inconsistent with the regulation.'" *Stinson v. United States*, 508 U.S. 36, 45 (1993) (citation omitted); *see Auer v. Robbins*, 519 U.S. 452, 461-462 (1997) (holding that an agency's reasonable interpretation of its own regulation is entitled to controlling weight even where its interpretation is "in the form of a legal brief"). Given that the regulations do not expressly exclude growth options or residual-business assets from § 1.482-4(b)'s definition of intangibles, the IRS's interpretation is not

plainly erroneous. To the contrary, the IRS's interpretation is not only compelled by the plain language of the regulation, but it is also the only interpretation that does not "stultify" the purpose of the regulations, as it requires Amazon-LUX to pay for access to assets that a party entering into the same transaction under the same circumstances with an unrelated party would have paid for. *Xilinx*, 598 F.3d at 1195-1196. The Tax Court's interpretation, in contrast, unreasonably allows valuable assets to be accessed "for free" (ER693), in violation of the governing arm's-length standard.

Indeed, recent legislation confirms that the IRS's interpretation is reasonable. In the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97), Congress amended the definition of "intangible property" in Section 936(h)(3)(B) (which is incorporated by reference in Section 482) to "clarif[y]" the "[s]cope of the definition of intangible property." Joint Committee on Taxation, *Comparison of the House- & Senate-Passed Versions of the Tax Cuts and Jobs Act*, JCX-64-17, at 48 (Dec. 7, 2017). As noted above, prior to the amendment, Section 936(h)(3)(B) defined "intangible property" in terms of 28 specific types of intangibles – the same 28 items listed in § 1.482-4(b)(1)-(5) – and "any similar item,

which has substantial value independent of the services of any individual." The 2017 legislation amended that definition in two ways. First, it added "goodwill, going concern value, or workforce in place" to the list of specific items included in the definition of "intangible property." Pub. L. 115-97, § 14221(a), 131 Stat. 2054, 2218 (codified at I.R.C. § 936(h)(3)(B)(vi)). Second, it clarified the catch-all category by replacing "any similar item, which has substantial value independent of the services of any individual" with "any other item the value or potential value of which is not attributable to tangible property or the services of any individual." *Id*. (codified at I.R.C. § 936(h)(3)(B)(vii)).

Because the amendment only clarifies – but does not change – the existing definition of intangibles, it "does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property," as Congress emphasized in the Conference Report. H.R. Rep. No. 115-466, at 661. That the amendment aligns so exactly with the IRS's position in this case is no coincidence. Congress was prompted to act by the Tax Court's contrary interpretation of the regulatory definition of intangible property, as evidenced by a footnote reference to the *Amazon* Tax Court decision in the Conference Report.

Id. at 661 n.1552. Congress's express reference to an ongoing "'dispute'" regarding the meaning of intangible indicates that the "'subsequent amendment is intended to clarify, rather than change, the existing law.'"[15] *Callejas v. McMahon*, 750 F.2d 729, 731 (9th Cir. 1985) (citation omitted).

In sum, the Tax Court's first rationale for rejecting the Commissioner's DCF method is unfounded.

D. The Tax Court's holding that the Commissioner may not determine the arm's-length buy-in payment in this case by reference (in part) to projected cash flows associated with future intangibles is wrong as a matter of common sense and as a matter of law

The Tax Court's second rationale for rejecting the Commissioner's DCF method is also unfounded. In this regard, the court concluded that the method is "irreconcilable with the governing regulations" (Op/ER88) because it values the pre-existing intangibles by reference to cash flows

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[15] That the amendment applies prospectively to transfers occurring after December 31, 2017, does not mean that Congress was changing the pre-amendment law. To the contrary, Congress expressly provided that the amendment should not be "construed to create any inference" regarding the definition of intangibles "with respect to taxable years beginning before January 1, 2018." Pub. L. 115-97, § 14221(c), 131 Stat. 2054, 2219.

expected to result, in part, from subsequently developed intangibles. (Op/ER82-88.) As demonstrated below, that conclusion (i) erroneously assumes that the subsequently developed intangibles resulted solely from the parties' intangible-development expenditures under the cost-sharing arrangement, and (ii) is based on a misreading of § 1.482-7A(g)(2).

1. The pre-existing and subsequently developed intangibles in this case are not wholly independent of each other

To begin with, the Tax Court's critique of the Commissioner's DCF method proceeds from the false premise that the pre-existing intangibles Amazon-US made available to the cost-sharing arrangement, on one hand, and the new intangibles developed under that arrangement, on the other, are wholly independent of each other. (Op/ER78, 82.) They are not. For instance, by gaining access to Amazon-US's existing technology-related intangibles in the context of a cost-sharing arrangement, Amazon-LUX gained access to such intangibles not merely for use in operating its business, but also for use in the ongoing development of new intangibles with Amazon-US. And in that capacity, those pre-existing intangibles unquestionably

contributed to the development of new technology-related intangibles – technology that Amazon-LUX would co-own going forward – by giving the parties a head start in their research and development activities. (ER369-370, 441-448, 539, 573-578, 634-636, 638-639, 677-678.) Quite simply, existing technology begets new technology.

More importantly, through the ongoing collaboration that a cost-sharing arrangement entails, Amazon-LUX gained access to the residual-business assets that Amazon-US brought to bear on the arrangement, such as its culture of relentless product innovation and its R&D workforce-in-place. As Cornell (Amazon-US's expert) emphasized in discussing the importance of these types of assets in the intangible-development process, "It's not just throwing money at something, it's having an organization in place that promotes and makes possible creative innovation. . . . [W]hat really seems to set the Apples and the Amazons apart is that they have developed these unique innovative cultures that keep churning out new products." (ER715.) If existing technology begets new technology, then product innovation begets the *need* for new technology, and R&D workforce-in-place – along with ongoing intangible-development expenditures (the "throwing

money at it" factor) – contributes to the conversion of existing technology into new technology.

Amazon-US's own experts acknowledged this overlap between pre-existing and subsequent intangibles. (ER673-678, 709-710.) Cornell conceded that new intangibles generated through the cost-sharing arrangement were attributable not only to intangible-development expenditures, but also in part to the more discrete categories of Amazon-US's pre-existing intangibles (*i.e.*, the technology-related intangibles) and in part to "the more nebulous intangibles such as growth options." (ER710.) Given that relationship, some portion of the cash flows expected to result from the new intangibles would necessarily be attributable to the pre-existing intangibles, making it appropriate to determine the buy-in payment by reference to those cash flows.

2. The Tax Court's valuation-limitation rule derives from a misreading of § 1.482-7A(g)(2)

Appeals to common sense aside, nothing in the 1995 cost-sharing regulations prohibits the IRS from determining the amount of the buy-in payment by reference to projected economic benefits associated with the intangibles expected to be developed under the cost-sharing

arrangement. The Tax Court's conclusion to the contrary, first adopted in 2009, is premised on a misreading of § 1.482-7A(g)(2).

The Tax Court's valuation-limitation rule derives from *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *nonacq.*, 2010-49 I.R.B. (Dec. 6, 2010), in which the court likewise held that the Commissioner's determination of the buy-in payment there violated the 1995 cost-sharing regulations by taking into account the anticipated value of subsequently developed intangibles. In support of that conclusion, the *Veritas* court merely pointed to the first sentence of § 1.482-7A(g)(2), which recites the general circumstances under which a buy-in payment must be made:

> If a controlled participant makes pre-existing intangible property in which it owns an interest available to other controlled participants for purposes of research in the intangible development area under a qualified cost sharing arrangement, then each such other controlled participant must make a buy-in payment to the owner. * * *

133 T.C. at 323. Although that sentence says nothing about how the pre-existing intangible property is to be *valued*, the *Veritas* court nonetheless construed it as precluding any valuation that takes into account anticipated income from subsequently developed intangibles, *i.e.*, any valuation that treats the existing intangible property as one of

the factors giving rise to the subsequently developed intangibles. *Id*. at 323-324.

The Tax Court here, relying heavily on *Veritas*, likewise construed the first sentence of § 1.482-7A(g)(2) as a valuation-limitation rule. (Op/ER70.) But the valuation rule applicable to buy-in payments is found in the second sentence of § 1.482-7A(g)(2):

> The buy-in payment by each such other controlled participant is the arm's length charge for the use of the intangible under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6, multiplied by the controlled participant's share of reasonably anticipated benefits (as defined in paragraph (f)(3) of this section). * * *

And the benchmark under those rules is the amount that Amazon-US would have charged an unrelated party had it "engaged in the same transaction under the same circumstances" with that party, *i.e.*, had it provided the use of its pre-existing intangibles in conjunction with a cost-sharing arrangement entered into with that party under the same circumstances. § 1.482-1(b)(1). In that situation, Amazon-US would not have accepted a buy-in payment that was based on the wholly artificial valuation-limitation rule that the Tax Court read into the first sentence of § 1.482-7A(g)(2).

E. The Tax Court misinterpreted the regulations' realistic-alternatives principle

The Tax Court's rejection of the DCF method also conflicts with the realistic-alternatives principle set forth in § 1.482-1(f)(2)(ii). Pursuant to that principle, the Commissioner may determine the arm's-length price for a related-party transaction by "consider[ing] the alternatives available to the taxpayer." *Id.* The regulations further emphasize that unspecified methods – such as the transfer-pricing method utilized by the Commissioner here – implement this principle by "provid[ing] information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction." § 1.482-4(d)(1). The realistic-alternatives principle is incorporated by reference in the cost-sharing regulations' buy-in requirement. § 1.482-7A(g)(1).

By expressly adopting the realistic-alternatives principle, the regulations codify the fundamental economic concept of opportunity cost. (ER433 (citing § 1.482-4(d)(1)), 787-789.) Pursuant to that concept, it is understood that uncontrolled parties acting rationally consider all choices realistically available to them and only enter into transactions that are preferable to the alternatives. (ER621-623, 787-

794.) An intangibles transaction with a related party that provides less economic benefit to the owner of the intangibles than the owner could have realized under its realistic alternatives does not achieve an arm's-length result. § 1.482-4(d)(1). As Frisch explained, it would be "inconsistent with arm's length" for a company considering a cost-sharing arrangement to "ignore" how much money it could make if it maintained exclusive access to its pre-existing intangibles and exclusive ownership of its subsequently developed intangibles. (ER757-758.)

As suggested in the preceding paragraph, one alternative available to Amazon-US at the time it entered into the cost-sharing arrangement with Amazon-LUX was to simply maintain the status quo and continue to receive the net cash flows from its European Business. (ER627-630.) The opportunity cost of entering into the cost-sharing arrangement with Amazon-LUX is measured by the long-term expected net cash flows related to the European Business that Amazon-US gave up. (ER628.) If Amazon-US had maintained the status quo, it would have expected cash flows of $2.9 billion net of the projected intangible-development costs and other expected outlays. (ER363-365, 746-748, 953.)

The realistic-alternatives principle is not a novel concept. Indeed, this Court applied the same common-sense analysis animating that principle long before it was incorporated into the 1994 regulations. *See Kerry Inv. Co. v. Commissioner*, 500 F.2d 108, 109-110 (9th Cir. 1974). In *Kerry*, this Court reversed the Tax Court's rejection of the Commissioner's Section 482 adjustment to an interest-free loan between related parties, reasoning that, if the lender had provided an unrelated party a loan, it would have been able to charge interest. *Id.* As this Court explained, when "a taxpayer lends $500,000 to a wholly owned subsidiary without interest, it is obvious that the lender is likely divesting itself of interest income that it could have earned by making interest-bearing loans in a competitive market." *Id.* Like the interest income that the lender in *Kerry* could have earned, the cash flows that Amazon-US could have realized from the European Business had it forgone the cost-sharing arrangement with Amazon-LUX is a valid consideration when pricing the buy-in payment at issue.

The Tax Court misapprehended the realistic-alternatives principle. (Op/ER82-85.) The court concluded that the principle has no role in this case because the IRS may not (i) "restructure" the parties'

transaction or (ii) deny Amazon-US the right to enter into a cost-sharing arrangement. (Op/ER84.) Both observations miss the mark.[16]

The realistic-alternatives principle does not *restructure* a transaction. Rather, it *re-prices* a transaction just as the taxpayer has structured it by examining the taxpayer's alternatives. *See* §§ 1.482-1(f)(2)(ii)(B) (example), 1.482-4(d)(2) (example). Here, Frisch did not restructure the parties' cost-sharing arrangement into a realistic alternative. Rather, he evaluated the buy-in price for the cost-sharing arrangement as elected by the taxpayer by reference to Amazon-US's realistic alternative – that is, by reference to the cash flows Amazon-US could have realized from the European Business had it not entered into the cost-sharing arrangement.

The Tax Court's "restructure" critique conflicts with § 1.482-1(f)(2)(ii)(A). The third sentence of that section explains that the realistic-alternatives principle does not operate to restructure the

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[16] The Tax Court's error has been noted by the tax bar. As one tax practitioner explained, the *Amazon* decision "misinterpreted the realistic alternatives principle," which is "not a very complicated concept that you will not do something that hurts yourself." Ryan Finley, *IRS Focus on Economic Concepts in Doubt After Amazon Decision, Practitioners Say*, 2017 Worldwide Tax Daily 139-1 (July 21, 2017).

controlled transaction itself but merely provides a benchmark price for evaluating the price charged in the controlled transaction. In this regard, if the controlled price is less than the benchmark price, the regulation directs the IRS to "adjust the consideration charged in the controlled transaction" to align with the "profit of an alternative." *Id.* But – as the regulation makes clear – adjusting the price does *not* result in "restructur[ing] the transaction as if the alternative had been adopted by the taxpayer." *Id.*

Nor does the realistic-alternatives principle deny Amazon the right to enter into a cost-sharing arrangement. It only denies Amazon-US's attempt to enter into a cost-sharing arrangement without having its foreign affiliate pay an arm's-length price for access to its pre-existing intangibles. Amazon is not "entitled" (Op/ER84) to move a portion of the benefits flowing from its U.S.-created intangibles beyond the reach of the U.S. tax system for anything less than an arm's-length consideration. And requiring an arm's-length buy-in payment does not make the cost-sharing election "altogether meaningless" (Op/ER83). Once the arm's-length amount of the buy-in payment is established, Amazon enjoys all the benefits of the cost-sharing arrangement,

including the sweetheart deal with the Luxembourg taxing authorities and avoidance of future transfer-pricing disputes with the U.S. taxing authorities regarding the value of any subsequently developed intangibles.

Finally, the Commissioner's reliance on the realistic-alternatives principle in this case was not an "attempt to apply the [2009/2011 cost-sharing] regulations retroactively," as the Tax Court wrongly supposed (Op/ER85 n.21). As noted above, the realistic-alternatives principle is a key provision in the 1994 transfer-pricing regulations, §§ 1.482-1(f)(2)(ii), 1.482-4(d)(1), which are expressly incorporated in the 1995 cost-sharing regulations. *See* § 1.482-7A(a)(2), (g)(2). Although the 2009/2011 regulations also refer to the realistic-alternatives principle, the principle was well established in the earlier regulations that apply here.

F. The Tax Court's remaining criticisms of the Commissioner's DCF method are unfounded

1. The Commissioner's DCF method does not charge Amazon-LUX twice for the subsequently developed intangibles

The DCF method is designed to capture *all* of the projected value of the European Business attributable to the pre-existing intangibles.

Moreover, it is designed to capture *only* that value; it does not require Amazon-LUX to pay "twice" for the subsequently developed intangibles, as the Tax Court incorrectly assumed. (Op/ER78, 108.) The mechanics of Frisch's DCF analysis preclude such double billing, as explained below.

The DCF method is a mathematical formula that can be arranged to solve for any variable. (ER459.) Frisch arranged the formula so as to solve for the present value of the pre-existing intangible assets that Amazon-US made available to Amazon-LUX. As the experts explained, the European Business's expected future cash flows are attributable to the following:

- Amazon-US's pre-existing intangibles,
- Amazon-LUX's anticipated cost-sharing payments,
- Amazon-LUX's tangible assets, and
- the operating efforts of Amazon's European Subsidiaries.

(ER378-384, 461, 467-469, 502-504, 546, 561.) Frisch's DCF method isolated the first category by subtracting the remaining categories (which had known expected values) from the projected cash flows, and

thereby backed into the unknown value of the pre-existing intangibles. (*Id.*)

Because Frisch's DCF method computes value *net* of Amazon-LUX's cost-sharing payments and other expenses (including its payments to the European Subsidiaries for their operating efforts), Amazon-LUX's contributions are factored out of Frisch's analysis. (ER363-365, 461, 468, 634-636, 694, 724-726, 746-748.) If the future revenues are not attributable to Amazon-LUX's anticipated contributions, which are eliminated from the DCF analysis, then the revenues must be attributable to Amazon-US's pre-existing intangibles. (ER369.) As Cornell conceded, projected income cannot be generated from thin air – it has to "come from something." (ER709.) *See* ER457-465 (extended example illustrating how Frisch's DCF analysis isolates the pre-existing intangibles). The only "something" left is the pre-existing intangibles.

Given the mechanics of the DCF computation, the Commissioner's DCF method does not require Amazon-LUX to pay twice for the same intangibles. (ER730.) As explained above, there is no overlap between the initial buy-in payment and the on-going cost-sharing payments

because Amazon-LUX's projected cost-sharing payments are subtracted from the projected cash flows *before* the net cash flows are discounted to compute the amount of the buy-in payment. (ER461, 468.)

Nor does the Commissioner's DCF method include in the buy-in payment the value of the European Subsidiaries' goodwill, going-concern-value, and workforce-in-place, as the Tax Court wrongly assumed (Op/ER80-81 n.19). That value was excluded by (i) calculating an arm's-length return to those subsidiaries for the services that they provided (derived from Amazon-US's own transfer-pricing analysis (ER724-725, 785-786)), and then (ii) subtracting that amount from the cash flows in the DCF computation before the net cash flows were discounted to calculate the buy-in payment.[17] (ER469, 667-668, 724-725, 764-770, 785-786.)

That Frisch assumed that some of the intangibles that Amazon-US made available to Amazon-LUX for research and development had an indefinite useful life does not mean that he "failed to restrict his

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[17] Frisch's buy-in payment includes the value of certain marketing intangibles that the Tax Court found were owned by the European Subsidiaries. (Op/ER148-153.) On remand, that value should be subtracted from the buy-in payment. *See*, below, § G.

valuation to the 'pre-existing intangible property,'" as the Tax Court concluded (Op/ER76). Although the court found that some of the intangibles had a useful life of 20 years or less, the court did not – and could not – find that Amazon-US's residual-business assets had such a limited useful life.[18] Moreover, because the DCF method backs into the value of the pre-existing intangibles, it is unnecessary to determine the useful life of any specific intangible in the bundle made available to Amazon-LUX; as long as the present value of the projected cash flows for the European Business exceeds the present value of Amazon-LUX's contributions, it necessarily follows that the excess amount is attributable to some portion of the bundle of pre-existing intangibles.

In short, Frisch *did* "limit his buy-in payment to the value of the pre-existing intangibles transferred pursuant to the [cost-sharing arrangement]" (Op/ER84-85), but that value derives in part from their contribution to the development of future intangibles.

[18] In any event, the DCF method is not dependent on including the terminal cash flows (*i.e.*, those beyond 20 years). (ER745.)

2. The Commissioner's DCF method does not "artificially cap" Amazon-LUX's profits

Similarly misconceived is the Tax Court's suggestion that the DCF method provides Amazon-US – through the buy-in payment – the economic benefit of "*all* future European business profits" generated by the subsequently developed intangibles in excess of Amazon-LUX's cost-sharing payments plus an arm's-length return thereon (Op/ER87 (emphasis added)). To the contrary, because the buy-in payment – a one-time toll charge – is determined by reference to projected cash flows, all future cash flows of the European Business that exceed the projected cash flows redound solely to the economic benefit of Amazon-LUX. (ER740-744.) Thus, the DCF method does not limit the *actual* economic benefit that Amazon-LUX may ultimately realize as the co-owner of the future intangibles; it only sets the maximum price that Amazon-LUX would be willing to pay "up front" for that unlimited upside, based on the European Business's projected cash flows, Amazon-LUX's projected cost-sharing payments, and the arm's-length rate of return on those payments. (ER679-682, 740-744, 759-763.)

Nor does the DCF method place an "artificial cap" on Amazon-LUX's "*expected* return[ ]" on its cost-sharing payments, as the Tax

Court incorrectly supposed (Op/ER87 (emphasis added)). Rather, the DCF method provides Amazon-LUX an expected rate of return on those payments based on the maximum expected rate of return that Amazon-US, in determining the amount to charge as the buy-in payment, would be willing to provide an unrelated party in Amazon-LUX's situation on that party's projected cost-sharing payments. In other words, the purported "cap" on expected returns is in no sense "artificial" but is instead the market rate of return (18%) that the court found was appropriate for Amazon-LUX's investment. (Op/ER126; ER695-696.) And, as explained above, there is no cap whatsoever on the *actual* returns that Amazon-LUX may enjoy. (ER742-744, 755-756.) The court's contrary finding that the Commissioner "allocat[ed] to [Amazon-US] all of [Amazon-LUX's] future profits in excess of the [18%] discount rate" (Op/ER88) is clearly erroneous.

G. Because the Commissioner's DCF method is the only method that accounts for the full value of all the pre-existing intangibles, and is fully compliant with the regulations, he could not have abused his discretion in selecting that method

As demonstrated above, the definition of "intangible" in § 1.482-4(b) encompasses "residual business assets" (Op/ER82), including

growth options, and therefore the IRS could not have abused its discretion in selecting an enterprise-based valuation method for determining the arm's-length buy-in payment in this case, as the Tax Court erroneously concluded. The experts agreed that, if all of the intangibles made available to Amazon-LUX were to be valued – and not merely a subset as the court erroneously concluded – then a DCF method was the most reliable way to value all of those intangibles. (ER455, 590-591, 716-717.) It was within the Commissioner's "broad discretion" to select the DCF method as the best method (Op/ER68), and the Tax Court's rationale for rejecting that method is wrong as a matter of law (as demonstrated above). Moreover, it was unreasonable for the Tax Court to utilize the CUT method to value the intangibles made available to Amazon-LUX in the cost-sharing arrangement because it is undisputed that the purportedly comparable transactions utilized by the court did *not* include access to Amazon-US's residual-business assets, particularly its growth options. (ER691-692.)

In light of the foregoing, this Court should hold that the Commissioner did not abuse his discretion in selecting the (unspecified) DCF method as the best method for determining the arm's-length buy-

in payment in this case, vacate the Tax Court's decision on that ground, and remand with instructions for the Tax Court to determine the proper application of the DCF method to the facts of this case. In that regard, certain adjustments to the Commissioner's DCF method may be required. First, the Tax Court found (and the Commissioner has not appealed) that some of the marketing intangibles were not made available by Amazon-US through the cost-sharing arrangement but were instead owned by Amazon's European Subsidiaries, which transferred them directly to Amazon-LUX. (Op/ER147-153.) As noted above (n.17), the Tax Court should adjust Frisch's buy-in payment downward on remand to reflect the value of those intangibles. Second, in the Tax Court, Amazon made several arguments regarding how (in its view) Frisch's DCF computations required certain adjustments. The Tax Court expressly did not address those arguments (Op/ER88-89 n.22) but should do so on remand.

CONCLUSION

The decision of the Tax Court should be vacated, and the case remanded for the court to determine an arm's-length buy-in payment utilizing the DCF method.

Respectfully submitted,

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MARCH 2018

STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, counsel for the Commissioner respectfully inform the Court that they are not aware of any cases related to the instant appeal that are pending in this Court.

ADDENDUM

Statute or Regulation (as in effect 2005-2006)	Page
Internal Revenue Code § 482 (26 U.S.C.)	82
Treasury Regulations (26 C.F.R.):	
26 C.F.R. § 1.482-1	84
26 C.F.R. § 1.482-4	106
26 C.F.R. § 1.482-7A	116

1776, 1834; Pub. L. 96–471, §2(b)(3), Oct. 19, 1980, 94 Stat. 2254.)

REFERENCES IN TEXT

The Internal Revenue Code of 1939, referred to in subsec. (b)(3)(C), is act Feb. 10, 1939, ch. 2, 53 Stat. 1, as amended. Prior to the enactment of the Internal Revenue Code of 1986 [formerly I.R.C. 1954], the 1939 Code was classified to former Title 26, Internal Revenue Code. Chapters 1 and 2 of the Internal Revenue Code of 1939 were comprised of sections 1 to 482 and 500 to 798, respectively, of former Title 26. Chapters 1 (except sections 143 and 144) and 2 were repealed by section 7851(a)(1) of this title. For table of comparisons of the 1939 Code to the 1986 Code, see Table I preceding section 1 of this title. See also section 7851(e) of this title for provision that references in the 1986 Code to a provision of the 1939 Code, not then applicable, shall be deemed a reference to the corresponding provision of the 1986 Code, which is then applicable.

AMENDMENTS

1980—Subsec. (d). Pub. L. 96–471 struck out subsec. (d) which provided that this section was not to apply to a change to which section 453 of this title, relating to change to installment method, applied.

1976—Subsec. (b)(1), (2). Pub. L. 94–455, §1901(a)(79)(B), struck out ", other than the amount of such adjustments to which paragraph (4) or (5) applies," after "required by subsection (a)(2)".

Subsec. (b)(4), (5), (6). Pub. L. 94–455, §1901(a)(79)(A), struck out par. (4) which related to special rule for pre-1954 general adjustments, par. (5) which related to special rule for pre-1954 adjustments in case of certain decedents, and par. (6) which related to the application of the special rule for pre-1954 general adjustments.

Subsec. (c). Pub. L. 94–455, §1906(b)(13)(A), struck out "or his delegate" after "Secretary".

1969—Subsec. (b)(3)(A). Pub. L. 91–172 substituted "loss carryback or carryover" for "loss carryover".

1958—Subsec. (a)(2). Pub. L. 85–866, §29(a)(1), inserted "unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer", after "does not apply".

Subsec. (b)(1). Pub. L. 85–866, §29(b)(1)–(3), inserted ", other than the amount of such adjustments to which paragraph (4) or (5) applies," after "subsection (a)(2)" and substituted "the aggregate increase in the taxes" for "the aggregate of the taxes" and "which would result if one-third of such increase in taxable income" for "which would result if one-third of such increase".

Subsec. (b)(2). Pub. L. 85–866, §29(b)(1), (4), inserted "other than the amount of such adjustments to which paragraph (4) or (5) applies," after "subsection (a)(2)", wherever appearing and "(or under the corresponding provisions of prior revenue laws)" after "the net increase in the taxes under this chapter".

Subsec. (b)(3)(A). Pub. L. 85–866, §29(b)(5), substituted "paragraph (1) or (2)" for "paragraph (2)", wherever appearing.

Subsec. (b)(4) to (6). Pub. L. 85–866, §29(a)(2), added pars. (4) to (6).

EFFECTIVE DATE OF 1980 AMENDMENT

For effective date of amendment by Pub. L. 96–471, see section 6(a)(1) of Pub. L. 96–471, set out as an Effective Date note under section 453 of this title.

EFFECTIVE DATE OF 1976 AMENDMENT

Amendment by section 1901(a)(79) of Pub. L. 94–455 effective for taxable years beginning after Dec. 31, 1976, see section 1901(d) of Pub. L. 94–455, set out as a note under section 2 of this title.

EFFECTIVE DATE OF 1969 AMENDMENT

Amendment by Pub. L. 91–172 applicable with respect to net capital losses sustained in taxable years beginning after Dec. 31, 1969, see section 512(g) of Pub. L. 91–172, set out as a note under section 1212 of this title.

EFFECTIVE DATE OF 1958 AMENDMENT

Section 29(d) of Pub. L. 85–866, as amended by Pub. L. 99–514, §2, Oct. 22, 1986, 100 Stat. 2095, provided that:

"(1) IN GENERAL.—The amendments made by this section [amending this section and section 381 of this title] shall apply with respect to any change in a method of accounting where the year of the change (within the meaning of section 481 of the Internal Revenue Code of 1986 [formerly I.R.C. 1954]) is a taxable year beginning after December 31, 1953, and ending after August 16, 1954.

"(2) EXCEPTION FOR CERTAIN AGREEMENTS.—The amendments made by subsections (a), (b)(1), and (c) [amending this section and section 381 of this title] shall not apply if before the date of the enactment of this Act [Sept. 2, 1958]—

"(A) the taxpayer applied for a change in the method of accounting in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, and

"(B) the taxpayer and the Secretary of the Treasury or his delegate agreed to the terms and conditions for making the change."

CHANGES IN TREATMENT OF POLICYHOLDERS DIVIDENDS BY QUALIFIED GROUP SELF-INSURERS' FUNDS

Pub. L. 101–239, title VII, §7816(m), Dec. 19, 1989, 103 Stat. 2421, provided that: "If, for the 1st taxable year beginning on or after January 1, 1987, a qualified group self-insurers' fund changes its treatment of policyholder dividends to take into account such dividends no earlier than the date that the State regulatory authority determines the amount of the policyholder dividend that may be paid, then such change shall be treated as a change in a method of accounting and no adjustment under section 481(a) of the Internal Revenue Code of 1986 shall be made with respect to such change in method of accounting."

TRANSITIONAL PROVISIONS FOR INCOME TAX TREATMENT OF DEALER RESERVE INCOME

Pub. L. 86–459, May 13, 1960, 74 Stat. 124, authorized any person who computed taxable income under the accrual method of accounting for his most recent taxable year ending on or before June 22, 1959, and who treated dealer reserve income for such taxable year as accruable for a subsequent taxable year, to elect before Sept. 1, 1960, to have section 481 of this title apply to the treatment for income tax purposes of dealer reserve income.

ELECTION TO RETURN TO FORMER METHOD OF ACCOUNTING

Section 29(e) of Pub. L. 85–866 authorized an election by certain taxpayers who, for any taxable years beginning after Dec. 31, 1953, and ending after Aug. 16, 1954, and before Sept. 2, 1958, computed their taxable incomes using different accounting methods in succeeding taxable years, to return to their first method of accounting, where the election was made within six months after Sept. 2, 1958. Claims for refunds of overpayments of tax resulting from the election were to be filed within one year after the date of the election. Such an election was to be considered a consent to an assessment of a deficiency resulting from the election, where the assessment is made within one year after the date of the election.

§482. Allocation of income and deductions among taxpayers

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, cred-

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its, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

(Aug. 16, 1954, ch. 736, 68A Stat. 162; Pub. L. 94–455, title XIX, §1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1834; Pub. L. 99–514, title XII, §1231(e)(1), Oct. 22, 1986, 100 Stat. 2562.)

AMENDMENTS

1986—Pub. L. 99–514 inserted at end "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

1976—Pub. L. 94–455 struck out "or his delegate" after "Secretary".

EFFECTIVE DATE OF 1986 AMENDMENT

Amendment by Pub. L. 99–514 applicable to taxable years beginning after Dec. 31, 1986, but only with respect to transfers after Nov. 16, 1985, or licenses granted after such date, or before such date with respect to property not in existence or owned by the taxpayer on such date, except that for purposes of section 936(h)(5)(C) of this title, such amendment applicable to taxable years beginning after Dec. 31, 1986, without regard to when the transfer or license was made, see section 1231(g)(2) of Pub. L. 99–514, set out as a note under section 936 of this title.

REGULATIONS

For requirement that, not later than 180 days after July 18, 1984, the Secretary of the Treasury modify the safe harbor interest rates applicable under the regulations prescribed under this section so that such rates are consistent with the rates applicable under section 483 of this title by reason of the amendments made by Pub. L. 98–369, see section 44(b)(2) of Pub. L. 98–369, set out as an Effective Date note under section 1271 of this title.

STUDY OF APPLICATION AND ADMINISTRATION OF THIS SECTION

Pub. L. 101–508, title XI, §11316, Nov. 5, 1990, 104 Stat. 1388–458, directed Secretary of the Treasury or his delegate to conduct a study of the application and administration of section 482 of the Internal Revenue Code of 1986 and not later than Mar. 1, 1992, submit to Committee on Ways and Means of House of Representatives and Committee on Finance of Senate a report on the study together with such recommendations as he deemed advisable.

§ 483. Interest on certain deferred payments

(a) Amount constituting interest

For purposes of this title, in the case of any payment—

(1) under any contract for the sale or exchange of any property, and

(2) to which this section applies,

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

(b) Total unstated interest

For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 1274(b)(2) using a discount rate equal to the applicable Federal rate determined under section 1274(d).

(c) Payments to which subsection (a) applies

(1) In general

Except as provided in subsection (d), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than 1 year after the date of such sale or exchange, and

(B) under which there is total unstated interest.

(2) Treatment of other debt instruments

For purposes of this section, a debt instrument of the purchaser which is given in consideration for the sale or exchange of property shall not be treated as a payment, and any payment due under such debt instrument shall be treated as due under the contract for the sale or exchange.

(3) Debt instrument defined

For purposes of this subsection, the term "debt instrument" has the meaning given such term by section 1275(a)(1).

(d) Exceptions and limitations

(1) Coordination with original issue discount rules

This section shall not apply to any debt instrument for which an issue price is determined under section 1273(b) (other than paragraph (4) thereof) or section 1274.

(2) Sales prices of $3,000 or less

This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000.

(3) Carrying charges

In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

(4) Certain sales of patents

In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), this section shall not apply to any

(1) Transfers to which section 421 applies.
(2) Deductions of foreign controlled participants.
(3) Modification of stock option.
(4) Expiration or termination of qualified cost sharing arrangement.
(E) 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.
(F) Consistency.
(3) Examples.
(e) Anticipated benefits.
(1) Benefits.
(2) Reasonably anticipated benefits.
(f) Cost allocations.
(1) In general.
(2) Share of intangible development costs.
(i) In general.
(ii) Example.
(3) Share of reasonably anticipated benefits.
(i) In general.
(ii) Measure of benefits.
(iii) 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.
(iv) Projections used to estimate anticipated benefits.
(A) In general.
(B) Unreliable projections.
(C) Foreign-to-foreign adjustments.
(D) Examples.
(4) Timing of allocations.
(g) Allocations of income, deductions or other tax items to reflect transfers of intangibles (buy-in).
(1) In general.
(2) Pre-existing intangibles.
(3) New controlled participant.
(4) Controlled participant relinquishes interests.
(5) Conduct inconsistent with the terms of a cost sharing arrangement.
(6) Failure to assign interests under a qualified cost sharing arrangement.
(7) Form of consideration.
(i) Lump sum payments.
(ii) Installment payments.
(iii) Royalties.
(8) Examples.
(h) Character of payments made pursuant to a qualified cost sharing arrangement.
(1) In general.
(2) Examples.
(i) Accounting requirements.
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(1) In general.
(2) Documentation.
(3) Requirements.
(ii) Coordination with penalty regulation.
(3) Reporting requirements.
(k) Effective date.
(l) Transition rule.

§ 1.482-8 Examples of the best method rule.

(a) In general.
(b) Examples.

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

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

(a) *In general*—(1) *Purpose and scope.* The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This § 1.482-1 sets forth general principles and guidelines to be followed under section 482. Section 1.482-2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances, services, and property. Sections 1.482-3 through 1.482-6 elaborate on the rules that apply to controlled transactions involving property. Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482-7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. Finally, § 1.482-8 provides examples illustrating the application of the best method rule.

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

form of an increase or decrease in any relevant amount.

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

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

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

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

(c) *Best method rule*—(1) *In general.* The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. See §1.482–8 for examples of the application of the best method rule. See §1.482–7 for the applicable method in the case of a qualified cost sharing arrangement.

(2) *Determining the best method.* Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in

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

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

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

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

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

(C) *Sensitivity of results to deficiencies in data and assumptions.* Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the

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

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

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

(i) Functions;

(ii) Contractual terms;

(iii) Risks;

(iv) Economic conditions; and

(v) Property or services.

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

(3) *Factors for determining comparability.* The comparability factors listed in § 1.482–1(d)(1) are discussed in this section. Each of these factors must

be considered in determining the degree of comparability between transactions or taxpayers and the extent to which comparability adjustments may be necessary. In addition, in certain cases involving special circumstances, the rules under paragraph (d)(4) of this section must be considered.

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

(A) Research and development;

(B) Product design and engineering;

(C) Manufacturing, production and process engineering;

(D) Product fabrication, extraction, and assembly;

(E) Purchasing and materials management;

(F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;

(G) Transportation and warehousing; and

(H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

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

(*1*) The form of consideration charged or paid;

(*2*) Sales or purchase volume;

(*3*) The scope and terms of warranties provided;

(*4*) Rights to updates, revisions or modifications;

(*5*) The duration of relevant license, contract or other agreements, and termination or renegotiation rights;

(*6*) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and

(*7*) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required even if no interest would be allocated or imputed under §1.482-2(a) or other applicable provisions of the Internal Revenue Code or regulations.

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

(*2*) *No written agreement.* In the absence of a written agreement, the district director may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of

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

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

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

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

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

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

(*4*) Credit and collection risks;

(*5*) Product liability risks; and

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

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

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

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

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

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

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

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

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

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

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

(A) The similarity of geographic markets;

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

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

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

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

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

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

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

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

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

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

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

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

(ii) *Different geographic markets*—(A) *In general.* Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in

economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, but the extent of such differences may affect the reliability of the method for purposes of the best method rule. For this purpose, a geographic market is any geographic area in which the economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions.

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

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)(i)(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.

(ii) *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)(ii).

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.

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The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.

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

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

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

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

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

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

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

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

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

section. Thus, the arm's length range in this case would be the range from $44 to $45.50.

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

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

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

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

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

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

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

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

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

taxable year even if the second controlled taxpayer does not realize income during such year. Finally, even if two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation under section 482 is not precluded.

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

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

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

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

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

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

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

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

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

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

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

Example 2. S1, S2, and S3 are Country Z subsidiaries of U.S. manufacturer P. S1 is the exclusive Country Z distributor of computers manufactured by P. S2 provides marketing services in connection with sales of P computers in Country Z, and in this regard uses significant marketing intangibles provided by P. S3 administers the warranty program with respect to P computers in Country Z, including maintenance and repair services. In evaluating the arm's length character of the transfer price paid by S1 to P, of the fees paid by S2 to P for the use of P marketing intangibles, and of the service

fees earned by S2 and S3. It may be appropriate to consider the combined effects of these separate transactions because they are so interrelated that they are most reliably analyzed on an aggregated basis.

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

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

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

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

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

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

(B) *Circumstances warranting consideration of multiple year data.* The extent to which it is appropriate to consider multiple year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data is available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible being examined. Data from one or more years before or after

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the taxable year under review must ordinarily be considered for purposes of applying the provisions of §1.482-1(d)(3)(iii) (Risk), §1.482-1(d)(4)(i) (Market share strategy), §1.482-4(f)(2) (Periodic adjustments), and §1.482-5 (Comparable profits method). On the other hand, multiple-year data ordinarily will not be considered for purposes of applying the comparable uncontrolled price method (except to the extent that risk or market share strategy issues are present).

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

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

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

Example 1. P sold product Z to S for $60 per unit in 1995. Applying the resale price method to data from uncontrolled comparables for the same year establishes an arm's length range of prices for the controlled transaction from $52 to $59 per unit. Since the price charged in the controlled transaction falls outside the range, the district director would ordinarily make an allocation under section 482. However, in this case there are cyclical factors that affect the results of the uncontrolled comparables (and that of the controlled transaction) that cannot be adequately accounted for by specific adjustments to the data for 1995. Therefore, the district director considers results over multiple years to account for these factors. Under these circumstances, it is appropriate to average the results of the uncontrolled comparables over the years 1993, 1994, and 1995 to determine an arm's length range. The averaged results establish an arm's length range of $56 to $58 per unit. For consistency, the results of the controlled taxpayers must

also be averaged over the same years. The average price in the controlled transaction over the three years is $57. Because the controlled transfer price of product Z falls within the arm's length range, the district director makes no allocation.

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

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

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

Example 3. FP manufactures product X in Country M and sells it to USSub, which distributes X in the United States. USSub realizes losses with respect to the controlled transactions in each of five consecutive taxable years. In each of the five consecutive years a different uncontrolled comparable realized a loss with respect to comparable transactions equal to or greater than USSub's loss. Pursuant to paragraph (f)(2)(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
C	4	7	13	8.00
D	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 C's result did not have a comparable effect over a comparable period of time on the results of C or the other uncontrolled comparables. In this case, the district director makes an allocation equivalent to adjusting FSub's gross profit margin for 1994 from 13% to the mean of the uncontrolled comparables' results for 1994 (7.25%).

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

employing sampling and other valid statistical techniques.

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

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

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

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

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

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

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

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

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

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

(C) Payment of the deficiency;

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

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

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

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

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

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

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

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

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

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

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

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

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the year of the transaction, with interest accruing therefrom.

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

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

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

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

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

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

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

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

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

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

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

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

(B) The taxpayer (or other member of the controlled group with respect to

which the restrictions apply) has exhausted all remedies prescribed by foreign law or practice for obtaining a waiver of such restrictions (other than remedies that would have a negligible prospect of success if pursued);

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(4) *Controlled* includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or

with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

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

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

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

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

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

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

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

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

(3) Although these regulations are generally effective for taxable years as stated, the final sentence of section 482 (requiring that the income with respect to transfers or licenses of intangible property be commensurate with the income attributable to the intangible) is generally effective for taxable years beginning after December 31, 1986. For the period prior to the effective date of these regulations, the final sentence of section 482 must be applied using any reasonable method not inconsistent with the statute. The IRS considers a method that applies these regulations or their general principles to be a reasonable method.

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

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(3)(v) of § 1.482-5 apply for taxable years beginning on or after August 26, 2003.

[T.D. 8552, 59 FR 34990, July 8, 1994, as amended by T.D. 9088, 68 FR 51171, Aug. 26, 2003]

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

(a) *Loans or advances*—(1) *Interest on bona fide indebtedness*—(i) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another

length result for a transfer of intangible property under §1.482-4. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, then the arm's length consideration for the transfer of that right must be determined separately under §1.482-4.

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

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

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

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

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

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

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

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

(1) Patents, inventions, formulae, processes, designs, patterns, or know-how;

(2) Copyrights and literary, musical, or artistic compositions;

(3) Trademarks, trade names, or brand names;

(4) Franchises, licenses, or contracts;

(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and

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

(c) *Comparable uncontrolled transaction method*—(1) *In general.* The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. The amount determined under this method may be adjusted as required by paragraph (f)(2) of this section (Periodic adjustments).

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

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

(iii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions

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

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

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

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

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

(*i*) The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited;

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

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

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

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

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

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

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

(*iv*) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled transaction method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to

apply this method. See §1.482-1(c) (Best method rule).

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

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

Example 1. (i) USpharm, a U.S. pharmaceutical company, develops a new drug Z that is a safe and effective treatment for the disease zeezee. USpharm has obtained patents covering drug Z in the United States and in various foreign countries. USpharm has also obtained the regulatory authorizations necessary to market drug Z in the United States and in foreign countries.

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

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

Example 2. The facts are the same as in *Example 1*, except that the incidence of the disease zeezee in Country Y is much higher than in Country X. In this case, the profit potential from exploitation of the right to make and sell drug Z is likely to be much higher in country Y than it is in Country X. Consequently, the Ydrug license agreement is unlikely to provide a reliable measure of the arm's length royalty rate for the Xpharm license.

Example 3. (i) FP, is a foreign company that designs, manufactures and sells industrial equipment. FP has developed proprietary components that are incorporated in its products. These components are important in the operation of FP's equipment and some of them have distinctive features, but other companies produce similar components and none of these components by itself accounts for a substantial part of the value of FP's products.

(ii) FP licenses its U.S. subsidiary, USSub, exclusive North American rights to use the patented technology for producing component X, a heat exchanger used for cooling operating mechanisms in industrial equipment. Component X incorporates proven technology that makes it somewhat more efficient than the heat exchangers commonly used in industrial equipment. FP also agrees to provide technical support to help adapt component X to USSub's products and to assist with initial production. Under the terms of the license agreement USSub pays FP a royalty equal to 3 percent of sales of USSub equipment incorporating component X.

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

(iv) The district director uses a database of company documents filed with the Securities and Exchange Commission (SEC) to identify potentially comparable license agreements between uncontrolled taxpayers that are on file with the SEC. The district director identifies 40 license agreements that were entered into in the same year as the controlled transfer or in the prior or following year, and that relate to transfers of technology associated with industrial equipment that has similar applications to USSub's products. Further review of these uncontrolled agreements indicates that 25 of them involved components that have a similar level of technical sophistication as component X and could be expected to play a similar role in contributing to the total value of the final product.

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

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

(B) Products for which the market could be expected to be of a similar size to the market for the products into which USSub incorporates component X;

(C) The transfer of patented technology;

(D) Continuing technical support;

(E) Access to technical improvements;

(F) Technology of a similar age; and

(G) A similar duration of the agreement.

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

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

License	Royalty rate (percent)
1	1.0
2	1.0
3	1.25
4	1.25
5	1.5
6	1.5
7	1.75
8	2.0
9	2.0
10	2.0
11	2.25
12	2.5
13	2.5
14	2.75
15	3.0

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

Example 4. (i) USdrug, a U.S. pharmaceutical company, has developed a new drug, Nosplit, that is useful in treating migraine headaches and produces no significant side effects. Nosplit replaces another drug, Lessplit, that USdrug had previously produced and marketed as a treatment for migraine headaches. A number of other drugs for treating migraine headaches are already on the market, but Nosplit can be expected rapidly to dominate the worldwide market for such treatments and to command a premium price since all other treatments produce side effects. Thus, USdrug projects that extraordinary profits will be derived from Nosplit in the U.S. market and other markets.

(ii) USdrug licenses its newly established European subsidiary, Eurodrug, the rights to produce and market Nosplit in the European market. In setting the royalty rate for this license, USdrug considers the royalty that it established previously when it licensed the right to produce and market Lessplit in the European market to an unrelated European pharmaceutical company. In many respects the two license agreements are closely comparable. The drugs were licensed at the same stage in their development and the agreements conveyed identical rights to the licensees. Moreover, there appear to have been no significant changes in the European market for migraine headache treatments since Lessplit was licensed. However, at the time that Lessplit was licensed there were several other similar drugs already on the market to which Lessplit was not in all cases superior. Consequently, the projected and actual Lessplit profits were substantially less than the projected Nosplit profits. Thus, USdrug concludes that the profit potential of Lessplit is not similar to the profit potential of Nosplit, and the Lessplit license agreement consequently is not a comparable uncontrolled transaction for purposes of this paragraph (c) in spite of the other indicia of comparability between the two intangibles.

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

reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

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

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

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

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

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

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

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

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

(*1*) The controlled taxpayers entered into a written agreement (controlled

agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under review;

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

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

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

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

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

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

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

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

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

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

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

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

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

(E) *Five-year period.* If the requirements of §1.482-4 (f)(2)(ii)(B) or (f)(2)(ii)(C) are met for each year of the five-year period beginning with the first year in which substantial periodic consideration was required to be paid,

then no periodic adjustment will be made under paragraph (f)(2)(i) of this section in any subsequent year.

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

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

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

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

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

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

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

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

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

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

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

(ii) The royalty rate for the license is based on a comparable uncontrolled transaction involving a comparable intangible under comparable circumstances. The requirements of paragraphs (f)(2)(ii)(A) through (D) 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,

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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)(B) has been met, and no adjustment under this section is made.

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

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

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

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

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

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

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

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

Example 4. The facts are the same as in *Example 2*, except that FP and USSub conclude a long term agreement under which USSub receives the exclusive right to distribute cheese in the United States under FP's trademark. USSub purchases cheese from FP at an arm's length price. Since USSub is the owner of the trademark under paragraph (f)(3)(ii)(A) of this section, and its conduct is consistent with that status, its activities related to the development of the trademark are not considered to be a service performed for the benefit of FP, and no allocation is made with respect to such activities.

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

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

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

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

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

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

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

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

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

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

[T.D. 8552, 59 FR 35025, July 8, 1994]

§1.482-5 Comparable profits method.

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

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

(2) *Tested party*—(i) *In general.* For purposes of this section, the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

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

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

estimate the relative values of these intangibles, the district director compares the ratios of the capitalized value of expenditures as of 1995 on Nulon-related research and development and marketing over the 1995 sales related to such expenditures.

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

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

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

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

§ 1.482–7 Sharing of costs.

(a) *In general*—(1) *Scope and application of the rules in this section.* A cost sharing arrangement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. A taxpayer may claim that a cost sharing arrangement is a qualified cost sharing arrangement only if the agreement meets the requirements of paragraph (b) of this section. Consistent with the rules of § 1.482–1(d)(3)(ii)(B) (identifying contractual terms), the district director may apply the rules of this section to any arrangement that in substance constitutes a cost sharing arrangement notwithstanding a failure to comply with any requirement of this section. A qualified cost sharing arrangement, or an arrangement to which the district director applies the rules of this section, will not be treated as a partnership to which the rules of subchapter K apply. See § 301.7701–3(e) of this chapter. Furthermore, a participant that is a foreign corporation or nonresident alien individual will not be treated as engaged in trade or business within the United States solely by reason of its participation in such an arrangement. See generally § 1.864–2(a).

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

(3) *Coordination with § 1.482–1.* A qualified cost sharing arrangement produces results that are consistent with an arm's length result within the meaning of § 1.482–1(b)(1) if, and only if, each controlled participant's share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of

reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

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

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

(1) Include two or more participants.

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

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

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

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

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

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

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

(v) The duration of the arrangement; and

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

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

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

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

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

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

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

United States, USS is not a qualified participant because it will not derive a benefit from the use of the intangible developed under the cost sharing arrangement.

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

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

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

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

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

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

(2) *Stock-based compensation*—(i) *In general*. For purposes of this section, a

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

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

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

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

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

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

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

or termination of the qualified cost sharing arrangement.

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

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

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

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

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

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

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

granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)(4) of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

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

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

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

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

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

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

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

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

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

(ii) For purposes of determining whether a cost allocation authorized by paragraph §1.482-7(a)(2) is appropriate for the first year, the district director must compare USP's

and FS's shares of intangible development costs for that year to their shares of reasonably anticipated benefits. See paragraph (f)(3) of this section.

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

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

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

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

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

(A) *Units used, produced or sold.* Units of items used, produced or sold by each controlled participant in the business activities in which covered intangibles are exploited may be used as an indirect basis for measuring its anticipated benefits. This basis of measurement will be more reliable to the extent that each controlled participant is expected to have a similar increase in net profit or decrease in net loss attributable to

the covered intangibles per unit of the item or items used, produced or sold. This circumstance is most likely to arise when the covered intangibles are exploited by the controlled participants in the use, production or sale of substantially uniform items under similar economic conditions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(iv) *Projections used to estimate anticipated benefits*—(A) *In general.* The reliability of an estimate of anticipated benefits also depends upon the reliability of projections used in making the estimate. Projections required for this purpose generally include a determination of the time period between the inception of the research and development and the receipt of benefits, a

projection of the time over which benefits will be received, and a projection of the benefits anticipated for each year in which it is anticipated that the intangible will generate benefits. A projection of the relevant basis for measuring anticipated benefits may require a projection of the factors that underlie it. For example, a projection of operating profits may require a projection of sales, cost of sales, operating expenses, and other factors that affect operating profits. If it is anticipated that there will be significant variation among controlled participants in the timing of their receipt of benefits, and consequently benefit shares are expected to vary significantly over the years in which benefits will be received, it may be necessary to use the present discounted value of the projected benefits to reliably determine each controlled participant's share of those benefits. If it is not anticipated that benefit shares will significantly change over time, current annual benefit shares may provide a reliable projection of anticipated benefit shares. This circumstance is most likely to occur when the cost sharing arrangement is a long-term arrangement, the arrangement covers a wide variety of intangibles, the composition of the covered intangibles is unlikely to change, the covered intangibles are unlikely to generate unusual profits, and each controlled participant's share of the market is stable.

(B) *Unreliable projections.* A significant divergence between projected benefit shares and actual benefit shares may indicate that the projections were not reliable. In such a case, the district director may use actual benefits as the most reliable measure of anticipated benefits. If benefits are projected over a period of years, and the projections for initial years of the period prove to be unreliable, this may indicate that the projections for the remaining years of the period are also unreliable and thus should be adjusted. Projections will not be considered unreliable based on a divergence between a controlled participant's projected benefit share and actual benefit share if the amount of such divergence for every controlled participant is less than or equal to 20% of the participant's projected benefit share. Further, the district director will not make an allocation based on such divergence if the difference is due to an extraordinary event, beyond the control of the participants, that could not reasonably have been anticipated at the time that costs were shared. For purposes of this paragraph, all controlled participants that are not U.S. persons will be treated as a single controlled participant. Therefore, an adjustment based on an unreliable projection will be made to the cost shares of foreign controlled participants only if there is a matching adjustment to the cost shares of controlled participants that are U.S. persons. Nothing in this paragraph (f)(3)(iv)(B) will prevent the district director from making an allocation if the taxpayer did not use the most reliable basis for measuring anticipated benefits. For example, if the taxpayer measures anticipated benefits based on units sold, and the district director determines that another basis is more reliable for measuring anticipated benefits, then the fact that actual units sold were within 20% of the projected unit sales will not preclude an allocation under this section.

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

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

Example 1. (i) Foreign Parent (FP) and U.S. Subsidiary (USS) enter into a cost sharing arrangement to develop a new car model. The participants plan to spend four years developing the new model and four years producing and selling the new model. USS and FP project total sales of $4 billion and $2 billion, respectively, over the planned four years of exploitation of the new model. Cost shares are divided for each year based on projected total sales. Therefore, USS bears $66\frac{2}{3}\%$ of each year's intangible development costs and FP bears $33\frac{1}{3}\%$ of such costs.

(ii) USS typically begins producing and selling new car models a year after FP begins producing and selling new car models. The district director determines that in

order to reflect USS's one-year lag in introducing new car models, a more reliable projection of each participant's share of benefits would be based on a projection of all four years of sales for each participant, discounted to present value.

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

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

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

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

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

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

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

Example 9. The facts are the same as in *Example 8*. In addition, the district director determines that FS2 has significant operating losses and has no earnings and profits, and that FS1 is profitable and has earnings and profits. Based on all the evidence, the district director concludes that the participants arranged that FS1 would bear a larger cost share than appropriate in order to reduce

FS1's earnings and profits and thereby reduce inclusions USP otherwise would be deemed to have on account of FS1 under subpart F. Pursuant to § 1.482-7(f)(3)(iv)(C), the district director may make an adjustment solely to the cost shares borne by FS1 and FS2 because FS2's projection of future benefits was unreliable and the variation between actual and projected benefits had the effect of substantially reducing USP's U.S. income tax liability (on account of FS1 subpart F income).

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

SALES
[In millions of dollars]

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

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

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

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

SALES
[In millions of dollars]

Year	USS	FP
1997	2	12
1998	17	35
1999	25	41
2000	38	41
2001	39	41

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

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

SALES
[In millions of dollars]

Year	USS	FP
1997	2	12
1998	17	35
1999	25	44
2000	34	54
2001	36	55

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

SALES
[In millions of dollars]

Year	USS	FP
2002	36	55
2003	35	56
2004	13	28
2005	4	14
2006	1.5	7

(iii) Combining the actual results through the year 2001 with the projections for subsequent years, and using a discount rate of 10%, the present discounted value of sales is approximately $131.3 million for USS and $229.4 million for FP. This result implies that USS and FP obtain approximately 36.4% and 63.6%, respectively, of the anticipated benefits from the Baldness treatment. These benefit shares diverge by greater than 20% from the benefit shares calculated based on the original sales projections, and the district director determines that, based on the difference between actual and projected benefit shares, the original projections were unreliable. The district director adjusts costs shares for each of the taxable years under examination to conform them to the recalculated shares of anticipated benefits.

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

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

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

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payment required under this paragraph (g)(2) is deemed to be reduced by such a share of payments owed from an uncontrolled participant to the same extent as by any payments owed from other controlled participants under this paragraph (g)(2). See paragraph (g)(8), *Example 5*, of this section.

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

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

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

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

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

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

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

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

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

Example 1. In year one, four members of a controlled group enter into a cost sharing arrangement to develop a commercially feasible process for capturing energy from nuclear fusion. Based on a reliable projection of their future benefits, each cost sharing participant bears an equal share of the costs. The cost of developing intangibles for each participant with respect to the project is approximately $1 million per year. In year ten a fifth member of the controlled group joins the cost sharing group and agrees to bear

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one-fifth of the future costs in exchange for part of the fourth member's territory reasonably anticipated to yield benefits amounting to one-fifth of the total benefits. The fair market value of intangible property within the arrangement at the time the fifth company joins the arrangement is $45 million. The new member must pay one-fifth of that amount (that is, $9 million total) to the fourth member from whom it acquired its interest in covered intangibles.

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

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

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

[All amounts stated in X's]

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

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

Example 5. A and B, two members of a controlled group form a cost sharing arrangement with an unrelated third party C to develop a new technology useable in their respective businesses. Based on a reliable projection of their future benefits, A and B agree to bear shares of 60% and 40%, respectively, of the costs incurred during the term of the agreement. A also makes available its existing technology for purposes of the research to be undertaken. The arm's length charge, under the rules of §§ 1.482-1 and 1.482-4 through 1.482-6, for the use of the existing

technology is 100X for the taxable year. Under its agreement with A and B, C must make a specified cost sharing payment as well as a payment of 50X for the taxable year on account of the pre-existing intangible property made available to the cost sharing arrangement. B's provisional buy-in payment before offsets to A for the taxable year is 40X (the product of 100X and B's anticipated benefits share of 40%). C's payment of 50X is shared provisionally between A and B in accordance with their shares of reasonably anticipated benefits, 30X (50X times 60%) to A and 20X (50X times 40%) to B. B's final buy-in payment (after offsets) is 20X (40X less 20X). A is treated as receiving the 70X total provisional payments (40X plus 30X) pro rata out of the final payments by B and C of 20X and 50X, respectively.

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

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

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

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

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

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

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

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

(B) The costs borne by each controlled participant;

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

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

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

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

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

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

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

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

[T.D. 8632, 60 FR 65557, Dec. 20, 1995, as amended by T.D. 8670, 61 FR 21956, May 13, 1996; 61 FR 33656, June 28, 1996; T.D. 8930, 66 FR 295, Jan. 3, 2001; T.D. 9088, 68 FR 51171, Aug. 26, 2003; 69 FR 13473, Mar. 23, 2004]

§ 1.482-8 Examples of the best method rule.

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

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Signature of Attorney or Unrepresented Litigant: s/ Judith A. Hagley

Date: March 30, 2018

("s/" plus typed name is acceptable for electronically-filed documents)

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CERTIFICATE OF SERVICE

I hereby certify that on March 30, 2018, I electronically filed the foregoing brief with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

/s/ Judith A. Hagley
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