Part 6
Transfer Pricing

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Chapter 22
Introduction to Transfer Pricing

§ 22.01. Income Shifting through Choice of Transfer Prices

U.S. tax authorities are given broad powers under Code section 482 to determine the proper taxpayer on income arising from transactions between related parties. Those powers are supported by the network of tax treaties that the United States has entered into with its major trading partners.[1] The tax authorities have exercised their statutory powers, through detailed Treasury regulations, to reduce the opportunities that persons engaged in transnational transactions otherwise would have for avoiding U.S. taxes.

The Treasury regulations issued under section 482 are designed to prevent taxpayers from shifting income to related parties that are exempt from U.S. tax or that are entitled to some special tax benefits, such as a preferential tax rate on their income.[2] The regulations currently in force were issued in 1994 and have been revised and embellished since then. They replace regulations issued in 1968. New regulations were required as a result of an amendment to Code section 482 by the 1986 tax act, which requires that income derived from the transfer of intangible property be "commensurate with the income attributable to the intangible."[3] The regulations are buttressed by penalties for noncompliance, which were adopted by Congress in 1990 and stiffened in 1993.

Taxpayers generally are required under Code section 482 to determine their income from transactions with related parties according to the arm's length standard.[4] The extensive Treasury regulations adopted in 1968 established and elaborated on that standard.[5] The 1994 regulations, as amended from time to time, have made some major changes in the legal regime governing transfer prices, correcting some technical defects in the old regulations, reversing (or attempting to reverse) some court interpretations of the old regulations that facilitated tax avoidance, and providing regulatory authority for some pricing methods that the Internal Revenue Service has used on audit for many years. The most notable feature of those

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[1] See, e.g., U.S. Model Treaty (2006), Art. 9.

[2] Since the early 1960s, IRC § 482 has played an increasingly important role in preventing international tax avoidance. It was initially adopted, however, to block domestic tax avoidance schemes, and it continues to serve that function.

[3] Some commentators believe that this commensurate-with-income standard is incompatible with the arm's length standard. The Treasury Department and the Internal Revenue Service issued a report in 1988 that attempted to reconcile the two standards. See Treasury Department and Internal Revenue Service, *A Study of Intercompany Pricing* (1988). In its gloss on the U.S. Model Treaty (1996), Treasury claims that the "implementation of this standard in the section 482 regulations is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines." See The Treasury Department, *Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006* (2006).

[4] Under IRC § 1059A, the arm's length price for goods imported into the United States cannot exceed the price declared for customs purposes.

[5] The 1968 regulations, which substantially amended prior regulations, were issued in response to an invitation of the Conference Committee Report on the Revenue Act of 1962 to "explore the possibility of developing and promulgating regulations under [the authority of section 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income." H.R. Rep. No. 2508, 87th Cong., 2d Sess. 18-19 (1962). The Conference Committee rejected a provision in the House version of the 1962 tax act that would have specifically authorized the Secretary of the Treasury to use formulas for allocating income between related parties when comparable arm's length prices are not available.

regulations, however, is their preservation of the form, and largely the substance, of the 1968 arm's length standard. There is new wine in the old skins, but only a few swallows.[6]

What has changed from the 1960s is the governmental strategy underlying the transfer pricing rules. In what may now be viewed as the good old days, the tax authorities, relying heavily on the presumption of correctness of their section 482 allocations, were able to settle informally most pricing disputes with taxpayers. Almost no reliance was placed on the threatened application of formal penalties to induce compliance. The real penalty imposed on those who set their transfer prices too aggressively was that the Service, on audit, would set prices that met some minimum standard of reasonableness but that produced very unfavorable results for the taxpayer. As the Tax Court and the courts of appeal became less supportive of the tax authorities in the 1980s, however, the old strategy collapsed.

The new strategy is to provide a substantial degree of flexibility to taxpayers in setting transfer prices but to punish them severely with formal penalties if they end up setting transfer prices that they cannot defend. The 1994 regulations, although not innovative in their basic design, do force taxpayers to comply with the regulatory rules—and document that compliance—at the time they initially set their transfer prices. Taxpayers that fail to do so face heavy penalties. Indeed, the stiffened penalties adopted by Congress in 1990 and 1993 are an integral part of the government's strategy for inducing "up-front compliance" with the transfer pricing rules.[7] This strategy can succeed only if the threat of penalties is credible. To be credible, the tax authorities must be willing to impose them and the courts must be prepared to sustain them as long as they have been imposed in accordance with the Code and regulations.

The objective of the arm's length standard is to require taxpayers engaging in transactions with related parties to report for tax purposes the income that they would have earned if they had engaged in comparable transactions with unrelated parties.[8] In the language of the 1994 regulations, the tax authorities are permitted to determine the "true taxable income of a controlled taxpayer" whenever "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 . . . been dealing at arm's length with an uncontrolled taxpayer."[9] A "controlled taxpayer" is defined as "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."[10]

In tax parlance, a "transfer price" is a price that a taxpayer has set in its dealings with a related party. Some restrictions on the ability of related parties to manipulate their transfer prices are necessary to preserve the residence jurisdiction and the source jurisdiction of the United States. Code section 482 protects U.S. residence jurisdiction by preventing related parties from shifting income from U.S. taxpayers to

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[6] The 1994 regulations carry over unchanged the 1968 regulations dealing with loans and advances, performance of services, and use of tangible property. Old typographical errors were corrected in Notice 95-21, 1995-1 C.B. 303, and the corrections were incorporated into the 1994 regulations in 1995. New regulations governing services were issued in 2009.

[7] For discussion of the compliance strategy of the Service by a former IRS official, see Robert E. Culbertson, "Speaking Softly and Carrying a Big Shtick: The Interplay Between Substantive and Penalty Rules in the U.S. Transfer Pricing Regulations," 11 *Tax Notes Int'l* 1509-1529 (Dec. 4, 1995).

[8] Reg. §§ 1.482-1(b)(1) (2012) and 1.482-1(d)(1) (2012).

[9] Reg. § 1.482-1(f)(1) (2012).

[10] Reg. § 1.482-1(i)(5) (2012).

foreign taxpayers.[11] Consider, for example, a U.S. parent corporation, PCo, making sales of goods to its wholly owned foreign subsidiary, SCo, followed by a sale of those goods by SCo to unrelated parties outside the United States. By setting sufficiently low transfer prices on the sales from PCo to SCo, the parties could shift all of the income from the sales transactions to SCo. Code section 482, however, would authorize the Internal Revenue Service to allocate some or all of the income from SCo to PCo for purposes of computing PCo's U.S. tax liability.

Code section 482 protects U.S. source jurisdiction in two ways. One way is by preventing related parties from improperly shifting U.S. source income from foreign taxpayers that are taxable on such income to foreign taxpayers that are not taxable on such income. Consider, for example, a Canadian corporation, CCo, that owns all of the stock of a Canadian subsidiary, UCo. CCo is not engaged in business in the United States and UCo is, through a permanent establishment. CCo sells goods to UCo in Canada, and UCo resells those goods within the United States through its permanent establishment. Under the U.S./Canada tax treaty, the United States generally cannot tax CCo on its sales income, but it can tax UCo. If CCo is permitted to sell its goods to UCo at an inflated price, however, UCo would have little or no income subject to taxation by the United States. Code section 482 requires that CCo set the price on sales to UCo according to the arm's length standard.

Another way that Code section 482 protects U.S. source jurisdiction is by preventing related parties that are obtaining income from operations within the United States from improperly assigning some or all of that income to transactions that generate either foreign source income or U.S. source income subject to a preferential tax rate. Consider, for example, two French corporations, FCo and its wholly owned subsidiary, UCo. UCo is engaged in manufacturing through a permanent establishment within the United States. It is taxable at normal corporate rates on its net income effectively connected with its U.S. trade or business. UCo enters into a contract to pay an inflated royalty fee to its French parent corporation, FCo, for use of a U.S. patent held by FCo.

Without the restrictions on transfer pricing imposed by Code section 482, the transaction described above would result in a lower aggregate U.S. tax burden on FCo and UCo. Under Code section 162, royalty fees paid by UCo to FCo are deductible by UCo in computing its effectively connected income. The royalty fees would be subject to tax under Code section 881, but the 30-percent withholding rate would be reduced under the U.S./France tax treaty. In these circumstances, Code section 482, by requiring an arm's length royalty fee, prevents the related parties from converting U.S. source manufacturing income, subject to the normal U.S. corporate tax, into U.S. source royalty income subject to a preferential rate.

The purpose that the Treasury regulations ascribe to Code section 482 is to promote "tax parity" between those taxpayers that engage in transactions with related parties and those otherwise similarly situated taxpayers that engage in comparable transactions with unrelated parties.[12] The goal of tax parity is

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[11] Other tax avoidance rules found in the Code, especially the anti-tax haven provisions of subpart F, also protect against attacks on U.S. residence jurisdiction.

[12] Reg. § 1.482-1(a)(1) (2012) (stating that the purpose of IRC § 482 is to place "a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of a controlled taxpayer"). The regulation writers use the term "true taxable income" without intended irony. It is defined circularly to be the income a controlled taxpayer would have obtained if it had dealt at arm's length with related parties. Reg. § 1.482-1(i)(9) (2012).

derived from the traditional tax policy goal of horizontal equity, which requires that taxpayers in equivalent economic situations pay the same amount of income taxes. Whether the taxes paid by equivalently situated taxpayers are collected by the U.S. government or by some foreign government would not matter for purposes of achieving horizontal equity or tax parity.

Notwithstanding the language of the Treasury regulations, tax parity is a subsidiary goal of the rules governing transnational transfers among related parties. The overriding purpose of Code section 482, as it applies to transnational transactions, is to protect U.S. tax revenues. Like the source of income rules, the primary function of the transfer pricing rules is to support U.S. claims for a fair share of taxes assessed on income arising from transnational transactions. Because of that revenue goal, related taxpayers cannot avoid an allocation of income under Code section 482 by offering proof that the foreign income taxes that they have paid were sufficiently high that the departure from the arm's length standard gave them no net tax advantage.

Code section 482 has been applied systematically to transnational transactions since the early 1960s. Until the late 1980s, however, the tax authorities focused very heavily on transactions between U.S. persons and their foreign affiliates. Increased attention is now being paid to transactions between foreign persons and their U.S. subsidiaries. Congress and the Internal Revenue Service apparently believe that many foreign persons are using inappropriate transfer prices to avoid or evade large amounts of U.S. income taxes.[13]

Virtually all countries with mature income tax systems employ some version of the arm's length standard to police the transfer prices of their taxpayers. In practice, that standard takes on significantly different meanings as it is implemented from country to country. Over the past two decades, the Organisation for Economic Co-operation and Development (OECD) has sought to achieve an international consensus on transfer pricing. In 1995, it issued a report that strongly endorsed the arm's length standard and gave a cautious endorsement of the principles embodied in the 1994 Treasury regulations.[14] As a member of the OECD, the United States has worked closely with it to build a consensus in support of the 1994 regulations.

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[13] For a Congressional study (using IRS data) indicating that foreign-owned distributors of electronic equipment, automobiles, and motorcycles were paying little or no U.S. taxes for taxable years 1977–1987, see Staff of Ways and Means Subcommittee on Oversight, "The U.S. Income Taxes Paid by Selected Foreign Corporations," July 10, 1994.

[14] See OECD Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) (looseleaf). For a general discussion of that report, see Brian J. Arnold & Michael J. McIntyre, *International Tax Primer* (1995) at 64–66. For a more detailed discussion from the perspective of the OECD, see Frances M. Horner, "International Cooperation and Understanding: What's New About the OECD's Transfer Pricing Guidelines," 13 *Tax Notes Int'l* 1065–1075 (Sept. 23, 1996).

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A. Introduction

A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example, if ACo manufactures goods in Country A and sells them to its foreign affiliate, BCo, organized in Country B, the price at which that sale takes place is called a transfer price. A transfer price is usually contrasted with a market price, which is the price set in the marketplace for transfers of goods and services between unrelated persons.

Multinational companies use transfer prices for sales and other transfers of goods and services within their corporate group. These intercompany prices are the most important category of transfer prices. Transfer prices are also used by individuals dealing with corporations or other entities under their control and by individuals dealing with close family members.

Unless prevented from doing so, related persons engaged in cross-border transactions can avoid the income taxes of a country through their manipulation of transfer prices. For example, in the example above, ACo might avoid paying income taxes in Country A by setting a price on the sale of its manufactured goods to BCo that results in its earning little or no profit. If the effective tax rate in Country B is lower than the effective tax rate in Country A, then the total tax burden of the affiliated companies ACo and BCo would be reduced through the use of inappropriate transfer prices. If Country B is a tax haven, then the affiliated companies would pay little or no tax on their combined profits.

In a well-designed income tax system, the tax authorities should have the power to adjust, in appropriate cases, the transfer prices set by related persons. This power should include the power to allocate gross income, deductions, credits, and other allowances among related persons so that the country collects its fair share of tax revenue from economic activities conducted within its borders.

In general, related persons should be defined to include two or more persons that are owned or controlled, directly or indirectly, by the same interests. A good indicator of such a relationship is the ability to set transfer prices that differ from market prices.

As suggested above, the tax authorities should be given the power to adjust transfer prices to prevent taxpayers from shifting income to related persons organized in tax havens or in countries where they enjoy some special tax benefit. Examples of tax benefits include a relatively low tax rate, a tax holiday or other tax incentive, and a tax-deductible loss. Although taxpayers generally do not seek to deflect income to a country that has high statutory tax rates, they may do so when a member of their affiliated group has losses in that country or if they are able to exploit some loophole in the high-tax country's tax system.

The tax authorities of a country also need the power to adjust transfer prices to give the country leverage to prevent other countries from obtaining an unfair share of the tax revenue on income derived from cross-border transactions through overly aggressive enforcement of their transfer pricing rules. When one country is aggressive in making transfer price adjustments and another country is not, taxpayers engaged in transactions in both countries may divert income to the aggressive country in order to mitigate their risks of double taxation. In practice, the only country that has an international reputation for systematic and aggressive enforcement of its transfer pricing rules is the United States, although its reputation for aggressive enforcement may be exaggerated. Many countries have reputations for aggressive enforcement in particular industries, especially in the natural resource extraction industries.

Good transfer pricing rules may be important to buttress other governmental policies. For example, multinational companies have been known to use improper transfer prices to avoid currency controls and to minimize their exposure to import duties.

When an enterprise is engaging in cross-border transactions in two or more countries through affiliated companies and those countries all have the power to adjust the transfer prices of the affiliated companies, the enterprise may be subject to double taxation. For example, assume that DCo manufactures goods in Country D at a cost of 60 and sells them to an affiliate, ECo. ECo then sells the goods at retail in Country E for 150. DCo is taxable in Country D on its manufacturing profit and ECo is taxable in Country E on its sales profit. The affiliated group (DCo and ECo) has a net profit of 90 (150 – 60). Assume that Country D concludes that the proper transfer price on the sale from DCo to ECo is 130, whereas Country E concludes that the proper price on that sale is 65. In that event, double taxation will result because the combined group will have income of 90 but will be taxable on income of 155, as the following table shows:

		County D	Country E
(1)	Sales price on transfer from DCo to ECo	130	65
(2)	DCo's cost of manufacturing	60	60
(3)	Income to DCo	70	5
(4)	Retail sales price in Country E	150	150
(5)	Income to ECo (Line (4) – Line (1))	20	85
(6)	Total Income of DCo and ECo (Line (3) + Line (5))	90	90
(7)	Total income taxable by Country D (Line (3), 1st column) and Country E (Line (5), 2nd column) = 70 + 85 = 155		

The concern for double taxation illustrated in the above example would be allayed if countries applied uniform rules for adjusting inappropriate transfer prices. In an attempt to achieve some degree of uniformity, Article 9 of the OECD Model Treaty provides that transfer prices should be adjusted so that they reflect the prices that would have been set between unrelated enterprises acting independently. This so-called **"arm's length method"** has been adopted by most countries of the world. The wide acceptance of the arm's length method, however, masks substantial disagreements over the way the method should be applied in practice. The main transfer pricing methods employed for implementing the arm's length standard are described in section 4,B, below.

In accordance with Articles 9(2) and 25 of the OECD Model Treaty, most countries entering into tax treaties have committed themselves to consider making adjustments to the transfer prices used to compute taxable income of their taxpayers if those prices have been adjusted by a treaty partner in accordance with the arm's length standard. Assume, for example, that ACo manufactures goods at a cost of 20 and sells them to its foreign affiliate, BCo, at 40. BCo resells the goods to unrelated persons for 60. ACo is taxable in Country A, and BCo is taxable in Country B. Country A determines that the proper price for the sale to BCo should be 50 and increases ACo's taxable income by 10. If Country B concurs with Country A's determination of the proper transfer price, it should allow BCo to increase its costs by 10 and thereby reduce its taxable income by 10. A modification to a transfer price used by one taxpayer to take account of a modification made to the transfer price used by an affiliated taxpayer is referred to as a **"correlative adjustment."**

Conflicts between countries over transfer prices are commonplace, despite the good intentions expressed in their tax treaties. Most tax treaties provide that an enterprise subject to double taxation because the countries where it operates have set inconsistent transfer prices may seek redress through the competent authorities of those countries. The competent authorities are required to address the taxpayer's complaint, but they are not generally obligated by treaty to resolve it. A few newer treaties do include a procedure for binding arbitration. For a discussion of the dispute resolution mechanism included in most tax treaties, see Chapter 6,C,3.

In recent years, some countries have sought to reach agreement with their taxpayers on the methodologies to be used in setting transfer prices before a transfer pricing dispute has actually arisen. A major objective of the advance approval system is to reduce the high costs that taxpayers and the tax authorities typically incur in litigating disputes over transfer prices. A taxpayer wanting prospective approval of its pricing methodology with respect to one or more transactions typically submits a request to the tax authorities for an **"advance pricing agreement"** or APA. The taxpayer must give details about the pricing methodology that it intends to apply to the transactions covered by the APA and must explain why that methodology would produce an appropriate result. In some instances, two or more governments may use the dispute-resolution mechanism in their tax treaties to agree jointly on the pricing methodology to be used by a taxpayer. In 1999, the OECD issued guidelines for countries in developing joint APAs. For a discussion of the tax treaty aspects of APAs, see Chapter 6,C,3.

Beginning in the 1960s, the United States has taken a leadership role in developing techniques for limiting transfer pricing abuses. The definition of the arm's length standard contained in the US section 482 regulations promulgated in 1968 was initially controversial but is now widely accepted. Those regulations promoted three methods for determining the arm's length price: the comparative uncontrolled price (CUP) method, the resale price method, and the cost plus method. In 1995, the United States promulgated new transfer pricing regulations that endorsed some additional methods, to be applied primarily when products embodying intangible property are sold or licensed. Although initially quite controversial, those methods have now been accepted by many other governments and have been endorsed with qualifications by the OECD.

The OECD has been working for many years to achieve an international consensus on transfer-pricing rules. In 1979, the OECD published a report entitled *Transfer Pricing and Multinational Enterprises,* which advocated the adoption of the arm's length principle to determine the prices of transactions between associated enterprises. The 1979 report was supplemented by a report in 1984 entitled *Transfer Pricing and Multinational Enterprises: Three Taxation Issues,* which dealt with the mutual agreement procedure, banking, and the allocation of central management and service costs. In 1992, the OECD established a task force to review transfer-pricing developments in the United States. Another task force was established in 1993 to revise the 1979 and 1984 reports on transfer pricing. This effort led to a comprehensive and fundamental review of transfer-pricing issues. Pursuant to this review, in 1995, the OECD issued a major volume, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("OECD Guidelines").

The OECD Guidelines were published in a looseleaf format to accommodate subsequent revisions. Revisions were made in 1996 to deal with additional issues relating to intangibles and services. In 1997, a new chapter on cost contribution arrangements was added. Annexes were added in 1998 to give some practical examples of the operation of the guidelines and to suggest procedures for monitoring their implementation. As noted above, an annex was published in 1999 dealing with joint APAs. The expectation is that further refinements of the OECD guidelines will be published periodically. For example, a new chapter to deal with the application of the guidelines to PEs is under development.

Many countries have attempted to deal with perceived transfer pricing abuses by requiring multinational companies to provide the tax authorities with extensive, contemporaneous documentation to support the methods they used to establish their transfer prices. The idea is that by forcing multinational companies to establish their transfer prices in advance, a country can prevent after-the-fact shifting of income for tax avoidance purposes. Taxpayers failing to provide the requisite documentation may be subject to substantial penalties.

For example, assume that ACo, operating in Country A, is selling goods to BCo, a related corporation operating in Country B. The corporate tax rate is 40 percent in Country A and 20 percent in Country B. ACo sets its transfer prices on its sales to BCo to show a small profit in Country A and a large profit in Country B. After setting those prices and providing the documentation to Country A, ACo discovers that it will suffer a large tax loss in Country A from some unrelated operations. If its pricing methodology had not been fixed, ACo might have been strongly tempted to revise the methodology to deflect some income from Country B to Country A so that it could fully utilize the Country A losses. The contemporaneous documentation rules, however, may prevent such a revision.

The OECD Guidelines support the dual strategy of requiring contemporaneous documentation and penalizing taxpayers for failure to comply with the documentation requirements. Tax administrators are advised, however, to pursue that strategy with extreme caution so as to avoid imposing unfair or excessively burdensome obligations on taxpayers acting in good faith.

Countries can limit the most egregious forms of transfer pricing abuses by giving appropriate discretion and resources to their tax departments and by imposing stiff penalties on taxpayers that have not set their transfer prices in good faith. They can take away some of the incentive for transfer pricing abuses by setting their marginal tax rates at levels that are moderate by international standards. The adoption of specific legislation targeted at tax havens can also take away some of the incentive for transfer pricing abuses because taxpayers commonly set improper transfer prices so as to deflect their income to affiliated entities in tax havens. Chapter 5,C describes such anti-avoidance provisions. Countries can get some help in controlling transfer pricing abuses through cooperation with their tax treaty partners, particularly their close neighbours. Through their own determined efforts and through cooperation with their trading partners, countries may entertain the realistic hope of containing transfer pricing abuses. No country, however, should expect to solve completely its transfer pricing problems.

B. Arm's Length Method

An appropriate transfer price, according to international custom, is one that meets the so-called arm's length standard. This standard is met if a taxpayer sets its transfer prices in its dealings with related persons so that those prices are the same as the prices used in comparable dealings with unrelated persons.

The above statement of the goal of the arm's length standard provides little guidance as to how transfer prices should be established in concrete situations. Summarized below are some of the rules that various countries have adopted to give content to the arm's length standard. Section 4,B,1 deals with mechanisms for setting proper transfer prices on sales or other transfers of tangible property between related persons. Section 4,B,2 describes rules applicable to setting transfer prices when a group of related corporations shares common resources. Section 4,B,3 describes the rules that apply when related persons share intangible property that they have developed jointly. Treaty aspects of the arm's length standard are discussed in section 4,B,4.

The OECD Guidelines on transfer pricing strongly endorse the arm's length standard. At the same time, they acknowledge frankly that the application of that standard sometimes presents serious difficulties for taxpayers and tax administrations. The guidelines provide a valuable discussion of the factors to be considered in determining whether transactions between unrelated persons are comparable to the transactions actually entered into by members of a corporate group. Like most of the literature on the arm's length approach, however, the OECD Guidelines are better at highlighting the problems of establishing the comparability of controlled and uncontrolled transactions than they are at giving practical advice to tax administrators on how to cope with these problems.

1. Sales of Tangible Personal Property

Many methods are used throughout the tax world for determining the arm's length price on sales of tangible personal property. Five methods are discussed below. The first three methods — the comparable uncontrolled price method, the resale price method, and the cost plus method — are widely accepted by the international tax community. These methods, sometimes referred to as the traditional methods, were promoted by the United States in its section 482 regulations adopted in 1968. Unfortunately, these methods are extremely difficult, if not impossible, to apply in many important cases, especially in cases in which the products being sold incorporate valuable intangible property. The traditional methods are described in section 4,B,1.1.

The two other arm's length methods can be applied in more situations. The **profit-split method** is frequently used on an informal basis by tax authorities in settling disputes with taxpayers through internal appeal procedures. The **transactional net margin method** (TNMM), also known as the **comparable profit method** (CPM), was formally approved by the United States in revisions to the section 482 regulations finalized in 1994. The OECD, in its 1995 report on transfer pricing, suggests that these latter methods should be used only as a last resort. These methods are described in section 4,B,1.2.

1.1. Traditional Methods

Comparable Uncontrolled Price (CUP) Method

The comparable uncontrolled price (CUP) method establishes an arm's length price by reference to sales of similar products made between unrelated persons in similar circumstances. It is the preferred method if such comparable sales exist. This method is widely used for pricing oil, iron ore, wheat, and other goods sold on public commodity markets. It is also useful for pricing manufactured goods that do not depend substantially for their value on special know-how or brand names. It is not well adapted for pricing many intermediate goods, such as custom-made automobile parts, that are not generally sold to unrelated parties. Nor is it suitable for setting the price on sales of goods that are highly dependent for their value on the trade name of the producer. The operation of this method is illustrated by the following example.

Assume that PCo is a corporation organized in Country X. It manufactures wooden chairs in Country X at a cost of 40 and sells them to unrelated foreign distributors at 47 each. It also sells nearly identical chairs to SCo, a controlled foreign subsidiary, which resells the chairs to unrelated consumers at 70. If the conditions of the sales to SCo and the unrelated distributors are essentially equivalent, then the arm's length price on the sale to SCo is 47. Thus PCo would have a profit of 7 (47 – 40), and SCo would have a profit of 23 (70 – 47). If the difference in the conditions of the sale to SCo and the unrelated distributors is that the sales to unrelated distributors do not include delivery costs, whereas the sales to SCo do include delivery costs, the sales may still be considered comparable, although some adjustment must be made for freight and handling costs.

Resale Price Method

The resale price method sets the arm's length price for the sale of goods between related parties by subtracting an appropriate markup from the price at which the goods are ultimately sold to unrelated parties. The paradigm case for its application is the sale by the taxpayer of its manufactured goods to a related party acting as a distributor, followed by a resale to unrelated customers without any further processing of the goods. The appropriate markup is the gross profit, expressed as a percentage of the resale price, that distributors typically earn from similar transactions with unrelated parties.

Assume that PCo in the previous example makes no sales of furniture to unrelated parties and there are no comparable sales between unrelated third parties. Assume also that the only activity performed by SCo is to resell the chairs in a foreign market. Under these assumptions, the resale price method might provide the appropriate arm's length price. To use that method, it is necessary to determine the normal markup percentage of a distributor engaging in activities similar to those performed by SCo. If it is determined that export distribution firms operating independently earn commissions of 20 percent on the purchase and sale of products comparable to the wooden chairs, a 20 percent markup figure might be used in computing the arm's length price on sales from PCo to SCo. If the final resale price of chairs is 70 when SCo makes sales to unrelated foreign customers, then the arm's length price of the controlled sale between PCo and SCo under the resale price method is 56 (70 minus 20% of 70). Thus, PCo would have an arm's length profit of 16 (56 – 40) under the resale price method, and SCo would have a profit of 14 (70 – 56).

Cost Plus Method

The cost plus method uses the manufacturing and other costs of the related seller as the starting point in establishing the arm's length price. An appropriate amount of profit is added to these costs by multiplying the seller's costs by an appropriate profit percentage. This percentage is determined by reference to the gross profit percentage earned by the seller in transactions with unrelated parties or by comparable unrelated parties in transactions with unrelated parties. A paradigm case for the application of the cost plus method is a sale by a taxpayer of goods it has manufactured to a related party, with the related party affixing its brand name to the goods and selling them to unrelated customers.

Assume, for example, that PCo in the previous example sells furniture to SCo without any brand name affixed. SCo affixes its valuable brand name on the furniture and sells the furniture to customers in foreign markets. In such circumstances, the cost plus method may provide the appropriate arm's length price. It is determined that the practice in industries similar to wooden chair manufacturing is to obtain a gross profit of 25 percent of the costs of production. PCo's average cost of producing a chair, determined under generally accepted accounting principles (GAAP), is 40. Under these assumptions, the arm's length price under the cost plus method on sales of chairs from PCo to SCo is 50 (125% of 40). Some additions to or subtractions from the 50 may be appropriate to take into account any material differences in the profit markup for sales of wooden chairs and sales in similar industries.

Comparison of Traditional Methods

In the examples above, PCo and SCo were engaged in entrepreneurial activities that might result in an overall gain or an overall loss. Under the CUP method, the entrepreneurial gain or loss is allocated between PCo and SCo by reference to market activities of comparable companies. In the resale price method, the selling company, SCo, is guaranteed a profit and all of the entrepreneurial gain or loss is allocated to PCo, the manufacturing company. In the cost plus method, PCo is guaranteed a profit and the entrepreneurial gain or loss is allocated to SCo. The following table summarizes the income attributable to PCo and SCo under the three traditional methods.

	CUP Method	Resale Price Method	Cost Plus Method
(1) PCo's cost of goods sold	40	40	40
(2) SCo's sales price to related customers	70	70	70
(3) PCo's sales price to SCo	47	56	50
(4) Profit to PCo (Line (3) – Line (1))	7	16	10
(5) Profit to SCo (Line (2) – Line (3))	23	14	20
(6) Total profits to PCo and SCo	30	30	30
(7) Earner of entrepreneurial profit	shared	PCo	SCo

When a multinational group of corporations is engaged in the manufacture and sale of products that embody valuable intangible property, it is likely to earn substantial entrepreneurial profits. The CUP method generally cannot be applied when the goods sold embody valuable intangible property because the goods sold are likely to be unique. In some cases, however, the conditions required for applying the resale price method or the cost plus method will be met. If the manufacturing affiliate (PCo in the above example) is producing the goods in a low-tax country and the selling affiliate (SCo in the above example) is importing those goods into a high-tax country, the corporate group is likely to favour the application of the resale price method because that method will allocate the high entrepreneurial profits to the low-tax country of production. In contrast, if the country of production is a high-tax country and the country of sale is a low-tax country, the corporate group would prefer to use the cost plus method, which allocates the entrepreneurial profit to the country of sale.

1.2 Additional Methods

Profit-Split Method

Under the profit-split method, the worldwide taxable income of related parties engaging in a common line of business is computed. The taxable income is then allocated among the related parties in proportion to the contribution they are considered to have made in earning the income. This method typically is employed when none of the three traditional methods can be applied. If a group of affiliated companies has more than one product line, the profit split method might be applied separately to each product line. Indeed, there are a wide variety of ways that a profit-split method might be applied. A distinctive feature of the method is that it applies to aggregate profits from a series of transactions and not to individual transactions. The traditional methods, in contrast, are all based on individual transactions. The following example illustrates the application of a profit-split method.

PCo and SCo are related companies engaged in the production and sale of pharmaceuticals. PCo engages in extensive research operations and uses patented processes to manufacture the pharmaceutical products, which it sells to SCo. SCo repackages the products for retail sale, attaches its valuable trade name, and resells them through an extensive marketing operation. PCo does not make sales to unrelated parties, and there are no comparable sales of equivalent products to other unrelated parties. The repackaged products sold by SCo are not comparable to products sold by unrelated parties.

Under these conditions, some countries might use a profit-split method to establish an appropriate transfer price for the pharmaceuticals. Assume that PCo has costs of 300 and SCo has costs of 100. Assume also that the sales proceeds from aggregate sales by SCo to unrelated customers is 600. Under these facts, the corporate group has net profits of 200 (600 – (300 + 100)). If PCo's contribution to the enterprise accounts for approximately 75 percent of the total net profits, then a 75/25 split of the profits might be appropriate. Thus PCo would have profits of 150 and SCo would have profits of 50 under the profit-split method.

There are many possible variations of the profit-split method. One variation is to combine it with one or more traditional methods. The traditional methods might be used to allocate average profits from routine activities and the profit-split method might be reserved for dividing entrepreneurial profits from the exploitation of valuable intangible property.

Assume in the example above that PCo engages in routine production activities and SCo engages in routine sales activities. PCo has gross costs of production of 300, and unrelated companies engaged in comparable manufacturing activities earn a return of 20 percent of costs. Under these facts, PCo would have profits of 60 (20% of 300) allocated to it under the cost plus method. SCo has gross sales revenue of 600, and unrelated companies engaged in similar activities have a gross profit margin of 10 percent. Under the resale price method, SCo would have profits allocated to it of 60 (10% of 600). The remaining profits of 80 (200 – (60 + 60)) would be allocated under the profit-split method. Assuming the same 75/25 split is applied, then PCo has profits of 60 (75% of 80) under the profit-split method, for total profits of 120 (60 + 60). SCo has profits of 20 (25% of 80) under the profit-split method, for total profits of 80 (20 + 60).

For the profit-split method to operate fairly and effectively, some fair and effective method must be applied to determine the appropriate profit split. One approach recommended by the US regulations and the OECD is to look at the way profits are split between uncontrolled persons that are engaged in comparable activities. Unfortunately, such information is typically unavailable. Because the profit-split method is most likely to be applied when valuable intangible property is involved, a profit split based on the relative contributions of the related parties to the development of that intangible property might be appropriate.

Transactional Net Margin Method (TNMM) and Comparable Profit Method (CPM)

The transactional net margin method (TNMM), sometimes referred to as the comparable profit method (CPM), is a method that may be used under certain circumstances in determining transfer prices for sales of tangible and intangible property. Under TNMM, the taxpayer must establish, for itself or a related party (the tested party), an arm's length range of profits on a set of transactions. If the tested party's reported profits on those transactions fall within that range, then its transfer prices will be accepted by the tax authorities. If its profits fall outside that range, the tax authorities may adjust transfer prices so that the profits fall within the range, typically at the midpoint.

In very general terms, the profits of a tested party are determined under TNMM by determining the ratio of profits to some economic indicator for an unrelated person and then applying that ratio to calculate the profits of the tested party. Assume, for example, that the unrelated person has taxable income of 80 and invested capital of 800 and that invested capital is the economic indicator being used in applying TNMM. The ratio of taxable income to invested capital for the unrelated person is 80:800, or 10 percent. If the tested party has invested capital of 500, then under a simplified version of TNMM, its arm's length profits will be 50 (500 × 80/800).

To refine the application of TNMM, the taxpayer or the government would be required to make a TNMM calculation for more than one unrelated person. The more such calculations are made, the more reliable the results are likely to be. The arm's length profits of the tested party would be an amount falling within the range of profits determined under the several calculations. Statistical techniques might be applied to select the point within that range that would be deemed to be the tested party's arm's length profits. If the tested party is a related corporation rather than the taxpayer, then the profits of the taxpayer would be determined by subtracting the profits of the tested person, as determined under TNMM, from the combined profits of the two corporations.

Whether the taxpayer or a related person is used as the tested party depends on the facts and circumstances of the particular case. The objective is to have, as the tested party, the related corporation that is most similar with respect to its business functions to the unrelated corporations used as comparables. For example, assume that ACo manufactures goods in Country A, sells the goods to BCo, its wholly-owned subsidiary, and BCo markets the goods in Country B after affixing its valuable trade name to those goods.

Information necessary for applying the traditional pricing methods is not available, nor is it available for applying TNMM to ACo. The necessary information for applying TNMM to BCo, however, is available. In that case BCo would be the tested party, whether or not it is the taxpayer.

For many years, the Internal Revenue Service of the United States used CPM without formal authority in settling transfer pricing disputes with taxpayers. The revisions to the US section 482 regulations published in 1994 gave specific approval to the US tax authorities and to taxpayers to use CPM. The method also was endorsed by the OECD in its 1995 report on transfer pricing as the "transactional net margin method." Apparently some OECD members insisted on this name in order to suggest that the method, like the three traditional methods, is a transactional method. In fact, CPM is always applied to determine the profits arising from an aggregation of transactions.

To apply TNMM, the taxpayer must determine a range of profits that unrelated persons would be expected to earn from engaging in comparable transactions. The taxpayer can establish this range in a variety of ways. One way, illustrated above, is to determine the rate of return on capital employed by two or more unrelated parties engaging in activities that are broadly similar to the activities of the taxpayer. This rate of return on capital for each unrelated person is then multiplied by the amount of capital of the taxpayer (or tested party as the case may be). A second way is for the taxpayer to determine the ratio of operating profits to gross sales receipts for two or more comparable related persons and then apply these ratios to its own (or the tested party's) sales. A third way is to determine the ratio of gross profit to operating expenses for two or more related persons and then apply these ratios to its own operating expenses. Other economic indicators might also be used.

Assume, for example, that TCo, the tested party, is engaged in business activities similar in complexity and character to the activities of ACo and BCo, which are corporations unrelated to TCo and to one another. ACo and BCo have ratios of operating profits to gross receipts of 0.2 and 0.3, respectively. TCo has gross receipts of 200,000. Under TNMM, T's arm's length range of profits would be from 40,000 (200,000 × 0.2) to 60,000 (200,000 × 0.3). Assuming the various conditions for application of TNMM are met, TCo's arm's length profits would be deemed to be in the range of 40,000 to 60,000.

Once the TNMM range has been established, it is necessary to select some amount within that range for the arm's length profits of the tested party. In general, the US tax authorities accept the transfer prices shown on the taxpayer's books of account if the profits determined by using those prices fall within the TNMM range. If the taxpayer's reported profits fall outside the range, then the US tax authorities treat the midpoint of the range as the arm's length profits. If data for more than two unrelated persons were used to establish the TNMM range, then a weighted average of the resulting profit numbers would be used to establish the midpoint of the range.

TNMM and CPM can be manipulated, by the taxpayer and by the tax authorities, through their choice of comparable companies. To prevent systemic biases in favour of the taxpayer or the government, criteria need to be developed for selecting appropriate comparable companies. In addition, neutral rules should be applied to eliminate comparable companies that yield unreasonable results and to select the arm's length profits from within the TNMM range.

2. Sharing of Corporate Resources

Related corporations frequently share funds, credit lines, corporate headquarters, know-how, trade names, employees, and other corporate resources. The arm's length standard requires that the owner of the shared resources charge related parties an arm's length fee for their use. In theory, the fee should equal the amount that an owner of an equivalent resource would charge an unrelated party for its use. In practice, the appropriate arm's length price is difficult to determine. The difficulty arises in part because unrelated corporations do not share comparable resources very often.

Loans or Advances

Persons engaged in the business of making commercial loans should be required to use a rate of interest for loans or advances to related parties that reflects the current cost of borrowing. For related parties not in the business of making loans, many countries provide some safe harbor interest rate so that the interest rate charged on the loan will not be adjusted if it is within the safe harbor. For example, a country may allow taxpayers to use an interest rate pegged to the average cost of government borrowing.

Performance of Services

If marketing, managerial, administrative, technical, or other services are performed by one related party for the benefit of another, the person receiving the services should be required to pay a fee equal to the cost of providing the services plus an appropriate profit. If the services are also sold in the marketplace to unrelated parties, the price for the services can be determined by reference to the prices charged for those sales. When the services are not so sold, the problem of setting an appropriate arm's length price is formidable. Some countries have concluded that the best they can do is to require a charge at least equal to the direct and indirect costs of providing the services.

Use of Tangible Property

If tangible property, such as an office or equipment, is made available to one related party by another, the owner of the property should be required to charge the user an arm's length rental fee. The same rule should apply to subleases of tangible property.

Use or Transfer of Intangible Property

If intangible property, such as a patent right, is made available to a related party, the owner of the property should be required to charge whatever amounts would be charged to an unrelated person for the use of the property in similar circumstances. This charge might be set by reference to royalty rates charged on the same or similar property made available to unrelated parties. The arm's length price on the sale of intangible property typically is set by reference to the discounted value of the arm's length royalties anticipated over the life of the property. Obtaining data necessary to determine the proper arm's length royalty is often difficult, both for the government and for the taxpayer. Multinational companies are commonly accused of avoiding tax through the use of inappropriate royalty rates.

In 1986, the United States adopted legislation requiring that royalty rates charged between related parties be commensurate with the income from the intangible property. Under the arm's length standard, royalty rates generally are based on facts known or knowable at the time the royalty contract is concluded.

The commensurate-with-income standard requires periodic adjustments in royalty rates to reflect the actual experience of the parties in utilizing the intangible property. For example, if PCo, a US corporation, transfers patents and know-how to its Irish subsidiary that allows it to manufacture plastic contact lenses, the parties may be required under the commensurate-with-income standard to make periodic adjustments in the royalty charged for use of that property to reflect the level of profits earned by the Irish subsidiary from the manufacture and sale of the contact lenses.

The US regulations adopted in 1994 to implement the commensurate-with-income standard are drawn very narrowly and are not likely to apply in most cases. The OECD, in its 1995 report on transfer prices, has endorsed the limited application of a commensurate-with-income standard. That standard may be applied when it is clear under the facts and circumstances of a particular case that unrelated persons operating at arm's length would not have made an outright sale or a long-term licence of intangible property but instead would have entered into an arrangement that gave the transferring person a substantial share of the actual profits earned through use of the transferred intangible property.

§ 22.02. Section 482 in the Courts

U.S. Steel Corp. v. Comm'r

617 F.2d 942 (2d Cir. 1980), rev'g TC Memo 1977-140

Editor's Summary of Facts

The appeal is from a decision of the Tax Court (Quealy, J.) that arose out of the development by United States Steel Corporation ("Steel") of newly discovered Venezuelan iron mines in the 1950s. The question presented is whether the taxpayer had presented sufficient evidence to successfully overcome Commissioner's determination that payments between a parent and a subsidiary were not "arm's length" and thus were subject to reallocation under § 482 of the Internal Revenue Code. A second issue in the appeal is omitted. The court found for the taxpayer, holding that its evidence was sufficient to establish that it met the arm's length test.

Opinion of the Court (Lumbard, Circuit Judge)

Taxpayer, United States Steel Corporation, is a major vertically integrated producer of steel. In addition to steel-making plants, it owns iron ore mines in the United States and elsewhere. In 1947, Steel discovered a vast new source of iron ore in Cerro Bolivar, a remote part of northeastern Venezuela on the Orinoco River. The transport of Orinoco ore to the Atlantic required the dredging of an extensive channel. Steel proceeded to develop these mines at a cost of approximately two hundred million dollars. in 1949, Steel formed Orinoco Mining Company ("Orinoco"), a wholly-owned Delaware subsidiary, to own and exploit the Cerro Bolivar mines.

Orinoco began selling ore from its mines in 1953. Initially, the ore purchased by Steel from Orinoco was transported to the United States in chartered vessels owned by two independent companies, Universe Tankships, Inc., ("Universe") and Joshua Hendy Corp. ("Hendy"). But in December 1953, Steel incorporated another wholly-owned subsidiary, Navios, Inc., ("Navios") in Liberia. Navios, with its principal place of business in Nassau, in the Bahamas, was a carrier which did not own any vessels. From July 1954 on, Navios, instead of Steel, chartered vessels from Universe, Hendy, and other owners, and Steel paid Navios for the transport of ore from Venezuela to the United States. Navios was an active company, having in the period 1954-60 between 53 and 81 fulltime employees.

Although Steel was by far the largest customer of Navios, Navios sold its transport services to other domestic steel producers (collectively "the independents") and to foreign steel companies. The prices charged by Navios to other domestic ore importers during the relevant period were the same prices charged to Steel, though the rates charged to companies importing ore to countries other than the United States were different.

Like Navios, Orinoco did not sell exclusively to Steel, although its parent was by far its largest customer. Orinoco sold to the independents and to foreign steel companies at the same prices it charged Steel.

Orinoco sold ore bound for the United States FOB Puert Ordaz, Venezuela in an attempt to arrive at a fair market price in order to minimize conflict with the Venezuelan taxing authorities, who had the power to revalue, for taxation purposes, the price at which Orinoco sold its ore if they considered that price too low. United States prices of iron ore were set, during the period in question, by an annual auction of ore from the Mesabi range of Minnesota, which established the so-called "Lower Lake Erie" price. Through its subsidiary Oliver Mining Co., Steel sold significant amounts of Mesabi ore.

The prices charged by Navios to other domestic ore importers during the relevant period were the same prices charged to Steel.

Orinoco was subject to a Venezuelan tax of up to 50% on income, and to a United States tax of 48% on any residue not offset by foreign tax credits. Steel was subject to a United States tax of 48% of net income. Navios was subject to a 2.5% excise tax in Venezuela and no tax in the United States. Dividends paid by Navios to Steel, of course, would be taxed at a rate of 48%.

Navios was a highly successful venture: Steel found itself in 1960 with a wholly-owned subsidiary possessing nearly $80 million in cash and cash equivalents. Navios paid no dividends to Steel during the period involved in this case. In effect, then, Navios became an offshore tax shelter. But, as the Tax Court found, Steel's decision to create Navios is not in itself a justification for the Commissioner's reallocation of income, since Navios served a major business purpose unrelated to tax-shifting: allowing Steel to reap the cost savings of using a non-United States-flag fleet.

In the tax year 1957 through 1960, Navios earned approximately $391 million in gross revenues, all on the transport of iron ore from Venezuela to various points in the eastern continental United States and in Europe. Of this total, revenues from Steel amounted to $286 million, or 73% of the total; and from independent domestic steel purchasers $21 million, or 5% of the total.

Two steel companies, Bethlehem Steel and Eastern Gas and Fuel Associates, used other means of transportation for ore which they purchased from Orinoco. Bethlehem had mines and exported from Venezuela small quantities of ore from the Orinoco area prior to Steel's development of its mines. Bethlehem had earlier set up a transportation system from minehead to the United States to which it adhered during the period in question. Eastern Fuel and Gas, a much smaller concern, contracted directly with shipowners, including its own shipowning affiliates.

During 1957-60, there was no information publicly available from which a "market price" for the carriage of iron ore by sea could be determined. Unlike the practice in the oil tanker industry, for example, ship charter contract prices for ore carriage were not published.

The Commissioner determined that Navios had overcharged Steel by 25%, and allocated [about $52.1 million of] income from Navios to Steel [for tax years 1957-1961]. On the basis of these figures, the Commissioner asserted deficiencies against Steel [of about $48.1 million for those years].

The Tax Court reviewed the history of Steel's relations with its subsidiaries Navios and Orinoco and concluded that a § 482 reallocation was justified because Steel had caused Navios to charge rates such that, at all times, the delivered price of Orinoco-origin ore in the United States was equivalent of the Lower Lake Erie price. In the Tax Court's view, this equivalence served several purposes. First, it protected Steel's interest in the revenues of its subsidiary, Oliver Mining Co., by insuring that the Lower Lake Erie price was not undercut by cheaper foreign ore. Second, because Steel could be sure of selling its Orinoco production so long as the delivered United States price did not exceed the Lower Lake Erie price, it enabled Steel to earn "extra" profits. Third, such extra profits, because they were earned through Navios, were not subject to Venezuelan tax and were sheltered from United States tax.

Judge Quealy then reviewed the figures used by the Commissioner in his reallocation. The Commissioner had used an approach that looked to profits and determined that a certain percentage of Navios' profits was in excess of what would fairly reflect income. Judge Quealy, by contrast, used two alternative means of arriving at what Navios' revenues would have been had it charged a "market" price for its services. First, he extrapolated hypothetical rates for 1957-60 from what Universe and Hendy charged in their 1954 contracts with Steel, adding adjustments to account for increased costs, risk and profits. As a check on the accuracy of this historical approach, Judge Quealy also constructed hypothetical rates based on estimates of what Navios' costs had been in the taxable years in question, adjusting these estimates to allow for risk and profit. He then chose the method which, for each taxable year, would result in the lowest reallocation in favor of the government.

The figures arrived at by the Tax Court provide for reallocation of [$27 million of income] from Navios to Steel [for taxable years 1957-1960.]

We are constrained to reverse because, in our view, the Commissioner has failed to make the necessary showings that justify reallocation under the broad language of section 482, which provides in full:

> In any case 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 by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The Treasury Regulations provide a guide for interpreting this section's broad delegation of power to the Secretary, and they are binding on the Commissioner. Treas. Reg. 1.482-1(b) states in part that "[the] standard to be applied in every [§ 482] case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." This "arm's length" standard is repeated in Treas. Reg. 1.482-1(c), and this subsection makes it clear that it is meant to be an objective standard that does not depend on the absence or presence of any intent on the part of the taxpayer to distort his income.

Treasury Reg. 1.482-2(b) governs the situation presented by the case at bar, in which a controlled corporation performs a service for a controlling corporation allegedly "at a charge which is not equal to an arm's length charge as defined in subparagraph (3) of this paragraph." Subparagraph (3) defines an arm's length charge for a service which is an integral part of the business of the corporation providing it as "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts."

We think it is clear that if a taxpayer can show that the price he paid or was charged for a service is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties" it has earned the right, under the Regulations, to be free from a § 482 reallocation despite other evidence tending to show that its activities have resulted in a shifting of tax liability among controlled corporations. Where, as in this case, the taxpayer offers evidence that the same amount was actually charged for the same service in transactions with independent buyers, the question resolves itself into an evaluation of whether or not the circumstances of the sales to independent buyers are "similar" enough to sales to the controlling corporation under the circumstances, "considering all relevant facts." In our view, "considering all the relevant facts," the evidence was sufficient to show similar enough transactions with independent buyers to establish that the price Steel paid Navios was an arm's length price. The evidence referred to above consists of Steel's uncontested showing that the amounts Steel paid Navios for one transport were the same rates paid by other independent purchasers of Orinoco ore. The Commissioner argues that the payment of the same rates by Steel and by independent buyers does not alone show, "considering all the relevant facts," that Steel paid an arm's length price.

Judge Quealy found that although purchasers of Orinoco ore were not required to use Navios' transport services, "most purchasers would not be in a position to contract independently for transportation of the ore to the site of their mills." (T.C. Memo. 1977-140 at 62). But, as we have stated above, two steel companies, Bethlehem Steel and Eastern Fuel and Gas, did make such independent arrangements. Bethlehem was a large corporation with financial resources comparable to those of Steel, but Eastern was a relatively small company whose ability to do without Navios is persuasive evidence that Judge Quealy's reliance on the notion that independent steel buyers were somehow forced to use Navios out of economic necessity was misplaced.

[Table 1] sets forth the amount of ore carried for some of the larger independent United States buyers, and the resulting charges made by Navios, during the years in question.

Table 1

Year	*Name of Purchaser*	*Tonnage*	*Amount Paid to Navios*
1957	Shenango Furnace	150,027	$1,403,024
	Jones & Laughlin	55,517	497,341
	Pittsburgh Steel	157,252	1,422,247

Year	*Name of Purchaser*	*Tonnage*	*Amount Paid to Navios*
	Sharon Steel	268,216	2,587,853
	Youngstown S. & T.	83,697	814,215
	U.S. Steel	7,223,187	65,274,437
1958	Shenango Furnace	247,014	2,483,631
	Jones & Laughlin	.....	.....
	Pittsburgh Steel	54,445	528,535
	Sharon Steel	114,688	1,173,485
	Youngstown S. & T.	74,967	767,532
	U.S. Steel	8,116,477	76,042,677
1959	Shenango Furnace	299,480	2,975,927
	Pittsburgh Steel	.....	.....
	Sharon Steel	215,004	2,141,493
	Youngstown S. & T.	79,630	793,150
	U.S. Steel	8,716,798	80,278,352
1960	Shenango Furnace	66,377	410,863
	Pittsburgh Steel	.....	.....
	Sharon Steel	163,968	823,119
	Youngstown S. & T.	.....	.....

The figures [in the table] show that the shipments of Orinoco ore to independent American buyers represented a series of transactions substantial in both frequency and volume. Although Steel's shipments were larger, transactions on the order of the carriage of 100,000 tons of ore (for which Navios would have charged approximately $1 million) cannot be dismissed as an arrangement a company would make without some attention to the possibility of securing more favorable terms. Nor can purchasers like Pittsburgh Steel, Sharon Steel, Jones & Laughlin and Youngstown Sheet & Tube be considered commercially unsophisticated or incapable of bearing the costs of seeking lower rates. It is true, as the Commissioner points out, that none of the independent domestic purchasers bought enough in one year to fill one of the very largest ore carriers chartered by Navios, but Navios also chartered smaller vessels, down to 20,000 ton capacity, and thus any argument that the independents were forced, in effect, to pool their transport requirements is untenable.

In sum, the record shows that over four years' time half a dozen large corporations chose to use the services of Navios despite the fact that they were not compelled to do so. In such circumstances, we think the taxpayer has met its burden of showing that the fees it paid (which were identical to those paid by the independents) were arm's length prices. We do not say that, had different or additional facts been developed, the Commissioner could not have countered the taxpayer's showing and sustained the validity of his reallocation. Such a counter-showing would have required evidence that Navios' charges, although freely paid by other, independent buyers, deviated from a market price that the Commissioner could have proved existed — for example, if worldwide ore-shipping contracts had been recorded and published during the period in question.

The Commissioner also argues that the fact that Steel paid the same rates as the independents is itself sufficient evidence that Steel was overcharged. The reasoning behind this counter-intuitive argument is that, in essence, Steel's relationship to Navios was that of a long-term charterer while the independents were short-term charterers; and that it is axiomatic that a long-term charterer pays a lower annual rate than a short-term charterer, because a shipowner prefers the freedom from market vicissitudes offered by a long-term charter. We are not persuaded by this line of argument. This shipowner who locks himself into a long-term charter bears the risk that charter rates will go up. Moreover, Steel's relationship to Navios was not that of charterer at all; Navios chartered ships from Universe and Hendy, and Steel purchased Navios' services as a carrier. Thus the Commissioner's analogy is not persuasive.

The Commissioner also argues that the fact that Steel paid the same rates as the independents is itself sufficient evidence that Steel was overcharged. The reasoning behind this counter-intuitive argument is that, in essence, Steel's relationship to Navios was that of a long-term charterer.

The Commissioner also points out that some of the Orinoco ore was shipped to Great Britain, but that although the distance from Venezuela to Great Britain is, on the average, 54% greater than the distance to the United States, the rates charged by Navios were not 54% higher than the Venezuela-to-United States rates. We do not view this as persuasive. First, there is nothing in the record to support the premise of the Commissioner's argument that charter rates are or should be an arithmetical multiple of distance traversed, nor is there any expert evidence as to the additional *marginal* cost of transport to Britain. The British rates are therefore of only speculative relevance to this case. Second, it may be, as the Commissioner suggests, that Navios was constrained to set lower rates for its European customers than for its American customers because the effective ceiling on the price of delivered ore in Europe was set by the price of Swedish ore, while the effective American ceiling was set by the Lower Lake Erie price. If the former was lower than the latter, shipping rates to Europe might have to be reduced. But the fact that sellers of ore, providers of ore transport, and ore buyers were all influenced by the price of a competing product does not mean that a price is not an arm's length price.

There is, however, a more sophisticated version of this argument which is entitled to scrutiny. Assume that an unrelated carrier would charge, as its Venezuela-U.S. rate, an amount which, when added to the price of Orinoco ore sold FOB, equalled the Lower Lake Erie price. Assuming further common ownership of Navios and Steel, but not of Orinoco, no case could be made out that Navios' rates were not arm's length, because — for economic reasons unrelated to common ownership — the price the carrier charged was the price any carrier would have charged and thus the price that would have been arrived at in a transaction between unrelated buyers and sellers. But add to this the fact that Steel also controlled Orinoco and therefore could reduce the price of Orinoco ore in order to increase Navios' share. The resulting price for Navios' services — Lower Lake Erie price minus Orinoco FOB price — would not be an arm's length price because it would have been affected by Steel's ownership of Orinoco, though not by Steel's ownership of Navios.

Attractive as this argument is in the abstract, it is a distortion of the kind of inquiry the Regulations direct us to undertake. The Regulations make it clear that if the taxpayer can show that the amount it paid was equal to "the amount which was charged . . . for the same or similar services in independent transactions" he can defeat the Commissioner's effort to invoke § 482 against him. The amount paid for Navios' services by Sharon Steel, Youngstown Sheet & Tube and other corporations was the same price paid by Steel. The only question, then, is whether the transactions were "independent."

We think that "independent" in this context must be viewed in contrast to the concept of joint ownership or control that is at the core of § 482. The transactions between Navios and Jones & Laughlin, Sharon and Youngstown were "independent" in that Steel had no ownership or control interest in any of these firms and thus was not in a position to influence their decision to deal with Navios. To expand the test of "independence" to require more than this, to require that the transaction be one unaffected by the market power of the taxpayer, would be to inject antitrust concerns into a tax statute. But in § 482, a tax statute, it is appropriate to limit the concept of what is not "independent" to actions influenced by common ownership or control.

We do not think that in order so to hold it must be shown that Navios' prices were the result of a perfectly competitive market. Prices arrived at by independent buyers and sellers in arm's length transactions may vary from such a perfect market price depending on factors extraneous to § 482.

Of course, in some markets, all "arm's length" transactions would occur at truly competitive prices. But the more imperfect the market, the more likely it is that "arm's length" transactions will take place at prices which are not perfect market prices. To use § 482 to require a taxpayer to achieve greater fidelity to abstract notions of a perfect market than is possible for actual non-affiliated buyers and sellers to achieve would be unfair. Thus, for example, Judge Quealy's reliance on the fact that Bethlehem did not use Navios' services ("Presumably, Bethlehem found that it could do the job for less." T.C. Memo. 1977-140 at 68.) even if correct factually, is irrelevant. The fact that transactions take place in the market place at different price levels does not, by itself, prove that transactions between unrelated buyers and sellers, such as Navios and Jones & Laughlin are not at "arms's length." The Regulations say that "independent transactions with or between unrelated parties" are enough to insulate a taxpayer's price from § 482. We decline to use the "all relevant facts" clause to transform this limited approach into a requirement that the taxpayer's price be the result of a perfectly competitive market.

Nor does the statute require that all independent transactions be at the price taxpayer charged or paid; therefore, the fact that Orinoco ore bought by Bethlehem Steel was transported to the United States at rates different from what Navios charged Steel and other customers is irrelevant. Since there were independent transactions significant in number and dollar amount and occurring over a long period of time, we need not address the question of how many such "independent transactions" at the taxpayer's price would be needed to insulate taxpayer from § 482 in a situation where a preponderance of the "independent" transactions take place at a price far different from the price paid or charged by taxpayer.

In at least one portion of Judge Quealy's opinion, however, it appears that the reason he relied upon to hold Navios' charges too high is not at all a matter involving the comparison of rates Steel paid to those paid by other steel companies. He said that what the rates paid by Steel must be measured against in order to see if a § 482 reallocation is justified is "what might be a reasonable charge for a continuing relationship involving the transportation of more than 10 million tons of iron ore per year." Jr. App. at 69. If this is indeed the inquiry, then the fact that other steel companies paid Navios the same rates Steel did is irrelevant. Judge Quealy explicitly recognized this:

> The comparability tests in the regulations cannot be relied on because the transportation of iron ore on the basis proposed by the petitioner and Navios had never been done previously. There could be no "independent transactions with unrelated parties under the same or similar circumstances" within the meaning of section 1.482-1(d)(3) of the regulations. Jt. App. at 69-70.

We are constrained to reject this argument. Although certain factors make the operations undertaken by Navios for Steel unique— at one point, for example, Navios' ore-carriers were the largest of their kind in the world—the approach taken by the Tax Court would lead to a highly undesirable uncertainty if accepted. In very few industries are transactions truly comparable in the strict sense used by Judge Quealy. Every transaction in wheat, for example, is more or less the same, except for standard variations in amount, time of delivery and place of delivery. But few products or services are as fungible as wheat. To say that Pittsburgh Steel was buying a service from Navios with one set of expectations about duration and risk, and Steel another, may be to recognize economic reality; but it is also to engraft a crippling degree of economic sophistication onto a broadly drawn statute, which — if "comparable" is taken to mean "identical", as Judge Quealy would read it — would allow the taxpayer no safe harbor from the Commissioner's virtually unrestricted discretion to reallocate.

Questions

1. Although some of the underlying facts of *U.S. Steel* are unclear, what is certain is that Navios has earned extraordinary profits that no independent company similarly situated would be able to earn. No one would suppose, for example, that U.S. Steel would be able to sell its stock in Navios for some reasonable multiple of the earnings of Navios—all potential buyers would realize that the company could not continue to earn millions of dollars a year once its special relationship with U.S. Steel was severed. Given the plain fact of windfall profits to Navios, why then, does U.S. Steel win its case? Is the problem with the court? With the 1968 regulations under section 482? Or is this case just one of the abnormalities that a practical tax system must tolerate?

2. One possible explanation for Navios earning its huge profits is that it was contracting for shipping services at the long-term shipping rate and then selling those services to U.S. Steel and the independent buyers of iron ore at the short-term rate. That argument was made by the Commissioner, accepted by the Tax Court, and rejected by the Second Circuit. The theory is elaborated on in Gale Mosteller, "Comparability in the U.S. Steel Transfer Pricing Case," 55 *Tax Notes* 1251-1258 (June 1, 1992). If that explanation is correct, Navios, in effect, is earning a risk premium for entering into the long-term charters when in fact it was not incurring any risk, due to its relationship with its "captive" buyer. Assuming that the spread in the short-term and long-term shipping rates is the explanation for Navios' profits, should the IRS have won the case? What evidence not already presented to the court would it need to introduce to support its position? Is such evidence likely to be available? Do you think that the long-term shipping rate is consistently lower than the short-term rate?

3. Another possible explanation for Navios' windfall profits is that U.S. Steel, through its joint control of Orinoco and Navios, was setting an inflated price for shipping and a deflated price for iron ore. That pricing structure would allow U.S. Steel and its related companies to underpay taxes to Venezuela by understating

Orinoco's income. The so-called independent purchasers acquiring iron ore and shipping services from the U.S. Steel family of companies would not care about the allocation of their payments between iron ore and shipping services—they only care about the price of the package. If these are the true facts, should U.S. Steel win its case?

A problem with this "package" theory is that Orinoco was selling small amounts of iron ore (to Bethlehem Steel and Eastern Gas and Fuel Associates) unbundled from the shipping services. Do these unbundled sales demonstrate that Orinoco was selling iron ore at the market price, as the Court of Appeals seems to believe? Hint: Where do you expect that Bethlehem Steel was obtaining the iron ore that was shipped by Navios?

4. At the end of *U.S. Steel*, the court states that the result it reached is needed to provide taxpayers with a safe haven against the unbridled discretion of the Commissioner. Was it the intent of Congress or the drafters of the 1968 regulations to give the taxpayer such a safe haven?

5. Were U.S. Steel and its affiliates avoiding U.S. taxes or Venezuelan taxes? (The answer may be "both," but which country has the primary right to the revenue from the taxes being avoided?) From a tax policy perspective, should the United States be concerned if U.S. Steel is avoiding or evading Venezuelan taxes?

6. If *U.S. Steel* were being decided under the 1994 regulations, how would it come out? Is the "comparable uncontrolled price (CUP) method," as specified in Reg. § 1.482-3(a)(1) and (b) (1994), the "best method" to use in *U.S. Steel* within the meaning of Reg. § 1.482-1(c) (1994). Does the "best method" rule eliminate the "safe harbor" created by the Court of Appeals for the Second Circuit in that case? If the CUP method is used, should adjustments be made in the price charged by Navios on account of any of the factors listed in Reg. § 1.482-3(a)(2)(ii)(B) (1994)?

Look at examples 1 and 2 of Reg. § 1.482-1(d)(3)(ii)(C) (1994), dealing with volume discounts. Do you think the Service is attempting to overturn *U.S. Steel* with these examples? If so, has it succeeded? How would you argue for U.S. Steel in a post-1994 case? Look also at examples 1 and 2 of Reg. § 1.482-1(d)(3)(iii)(C) (1994), dealing with risk. How would this example and the accompanying legal rules affect the outcome in *U.S. Steel*?

7. Whatever the outcome under the 1994 regulations, the tax avoidance illustrated in *U.S. Steel* would be blocked by the subpart F rules. Those rules were adopted in 1962 and were not applicable to U.S. Steel for the years at issue in that case. Under subpart F, U.S. Steel would be taxable on a deemed dividend from Navios in the amount of its net shipping income (and any other subpart F income). Is subpart F the proper mechanism for dealing with the apparent abuse illustrated in *U.S. Steel*?

Bausch & Lomb Inc. v. Comm'r

933 F.2d 1084 (2nd Cir. 1991), aff'g 92 T.C. 5 (1989)

Opinion of the Court (Mahoney, Circuit Judge

In a notice of deficiency dated December 30, 1985 relating to the income tax liability of Bausch & Lomb Incorporated ("B & L") and its consolidated subsidiaries (the "B & L Group") for the tax years ended December 30, 1979, December 28, 1980, and December 27, 1981, the Commissioner reallocated to B & L a net amount of $2,359,331 for 1981, and $18,425,750 for 1982, of gross income that had been reported as income of B & L's wholly-owned subsidiary, Bausch & Lomb Ireland, Ltd. ("B & L Ireland"). Finding the

Commissioner's reallocations unreasonable, the Tax Court reduced them to $1,255,331 for 1981 and $4,173,000 for 1982. See *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525, 581, 611 & n.26 (1989). Decision was entered correspondingly determining the tax liability of the B & L Group for 1979-1981, and the Commissioner took this appeal. We affirm.

Background

The Tax Court's opinion provides a thorough presentation of the factual background of this case. See 92 T.C. at 529-80. We summarize the events most relevant to the issues presented for our determination. In doing so, we credit the findings of the Tax Court unless we perceive them to be clearly erroneous. See *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855, 861 (7th Cir. 1988); *B. Forman Co. v. Commissioner*, 453 F.2d 1144, 1152 (2d Cir.), cert. denied, 407 U.S. 934, 92 S. Ct. 2458, 32 L. Ed. 2d 817 (1972).

In 1978, B & L was a major participant in the soft contact lens industry, controlling upwards of 50.6 per cent of the United States market. Between 1978 and 1980, B & L prepared long range forecasts that predicted increasing demand for soft contact lenses in international markets, particularly in Europe. In 1978, B & L began to investigate the possibility of an overseas manufacturing facility to complement its existing plant in Rochester, New York. Responding to various incentives offered by the Industrial Development Authority of the Republic of Ireland ("IDA"), including a tax holiday on all export profits through 1990, B & L determined to establish a manufacturing facility in Waterford, Ireland. The Tax Court:

> found as fact that [B & L] had sound business reasons for the establishment of B & L Ireland. [B & L] had reason to believe that manufacturing capacity at its Rochester facility was inadequate to meet expected increases in soft contact lens demand. [B & L] determined that it was prudent to establish additional manufacturing capacity overseas in order to minimize regulatory delays, establish an alternative supply source to the Rochester facility, and to have a facility capable of more efficiently servicing the increasingly important European markets. Ireland was determined to be the location at which these objectives could be realized most cost effectively due to the incentives offered by the Republic of Ireland to induce the location of manufacturing facilities within the Republic. Since a non-Irish company could not receive [IDA-sponsored] financing, there were sound business reasons for incorporating an Irish manufacturing facility rather than merely operating the facility as a division of B & L.

92 T.C. at 582-83.

Accordingly, B & L Ireland was incorporated on February 1, 1980, and B & L, B & L Ireland, and the IDA entered into an agreement on or about February 10, 1981 that specified the incentives to be provided for the venture by the IDA and the reciprocal commitments undertaken by B & L and B & L Ireland. B & L Ireland agreed, *inter alia*, not to enter into any royalty commitments, except that B & L Ireland could pay royalties to B & L or any subsidiaries in an amount not to exceed five percent of B & L Ireland's annual net sales.

Among the reasons for B & L's success was its manufacturing expertise. In the early 1960s, a Czechoslovakian chemist developed the "spin cast" method of manufacturing soft contact lenses, a process that uses centrifugal force by injecting a mixture into a spinning mold. As a result of a number of licensing agreements and lawsuits, B & L obtained nonexclusive rights to use the patents secured on the first spin cast machines. B & L acquired two spin cast machines from the inventor and, between 1966 and 1981, made several significant process modifications that increased the yield of usable lenses to a commercially acceptable level. Through 1982, B & L was the only manufacturer in the United States using the cost effective spin cast method. Thus, B & L was able to produce lenses at a cost of $1.50 each, which was far below its competitors' costs. During 1981 and 1982, for example, a competitor of B & L had per unit costs of over $4.00 using a cast molding process, and over $6.00 using a lathing process.

In January 1981, B & L granted B & L Ireland a non-exclusive license to manufacture lenses using B & L's spin cast technology. In addition, the license agreement entitled B & L Ireland to any improvements resulting from B & L's ongoing research and development in the manufacture of contact lenses, and permitted B & L Ireland to sell soft contact lenses anywhere under B & L's trademarks. In exchange, B & L was to receive a royalty of five percent of the subsidiary's net contact lens sales. The agreement was terminable upon the written notice of either party.

> B & L was able to produce lenses at a cost of $1.50 each, which was far below its competitors' costs . . .of over $6.00.

B & L Ireland began manufacturing lenses in March 1981. It performed all processing, packaging, inspecting and labeling at its Waterford facility, with the exception of some insignificant expiration date labeling on a limited number of lenses done in Rochester in 1981. Thus, when lenses left Ireland, they were ready for sale to optical practitioners and chains. B & L Ireland's unit sales were 1,116,000 and 3,694,000 lenses for the years 1981 and 1982, respectively. B & L was under no contractual obligation to purchase any lenses from B & L Ireland, but sixty-one percent of B & L Ireland's total sales in 1981 and fifty-six percent in 1982 were to B & L for resale in the United States. The balance of B & L Ireland's sales were to overseas affiliates of B & L. Throughout that two year period, the intercompany transfer price was $7.50 per lens. The purchasers also paid the duty and freight charges, which in the case of B & L were $0.62 per lens.

The Commissioner's proposed deficiency sought to "reflect an arm's length consideration for the use of [B & L's] intangible assets by B & L Ireland" by limiting B & L Ireland to "a net profit before taxes of 20 percent of sales." The notice of deficiency, invoking section 482, accordingly reallocated from B & L Ireland to B & L taxable income in the amounts of $2,778,000 and $19,793,750 for the years 1980 and 1981, respectively, with an offsetting elimination of the royalty income that B & L Ireland had reported for those years, resulting in a net reallocation of $2,359,331 for 1981 and $18,425,750 for 1982. In response to B & L's petition to the Tax Court for redetermination of the deficiencies, the Commissioner further contended that the reallocation was necessary "because of the lack of arms-length pricing between" B & L and its subsidiary.

The Tax Court was presented with nearly 200 pages of stipulated facts, and conducted an eight day trial. At the outset of its opinion, the court determined that the transfer price that B & L paid to B & L Ireland for lenses and the royalty rate that B & L Ireland paid to B & L for use of its manufacturing technology and related intangibles had independent significance, and thus should be examined separately. 92 T.C. at 584. First, the court upheld the $7.50 per lens transfer price as adequately supported by comparable price data. *Id.* at 589-93. The court was also of the view that its determination could be sustained under the alternative resale price method. *Id.* at 593-94. Second, the court rejected the royalty rates suggested by each side and, drawing upon the expert testimony presented by the parties as well as other evidence in the record, concluded that reallocation should be based upon a royalty rate equal to twenty percent of B & L Ireland's net sales. 92 T.C. at 611.

This appeal followed.

Discussion

We consider at the outset the standards governing our review. We are guided by *Eli Lilly & Co.*, which addressed this question as follows:

> We are unaware of any decision discussing the standard that governs appellate review of a Tax Court's reallocation. One might argue that appellate review of the Tax Court's allocations should parallel the Tax Court's review of the Commissioner's allocation — that the allocation should be upheld unless a de novo review of the facts shows it to be arbitrary, capricious or unreasonable. However, we lack the fact-finding capabilities that are essential to resolving factual discrepancies under that standard — especially conflicts involving disparate expert testimony. Our usual standards of review must therefore apply. The Tax Court's legal conclusions will receive plenary review. Factual findings will be reversed only if "clearly erroneous." *Anderson v. City of Bessemer City*, 470 U.S. 564, 573, 105 S. Ct. 1504, 1511, 84 L. Ed. 2d 518 (1985). "Mixed questions of law and fact," entailing the application of a legal standard to a given factual pattern, are reviewed under the clearly erroneous standard. *Standard Office Bldg. Corp. v. United States*, 819 F.2d 1371, 1374 (7th Cir. 1987). Id., 856 F.2d at 860-61; see also *B. Forman Co.*, 453 F.2d at 1152.

We next address the merits of the appeal. In doing so, we will follow the approach of the Tax Court, addressing seriatim: (1) whether the transfer price that B & L paid to B & L Ireland for lenses and the royalty rate that B & L Ireland paid to B & L for use of its manufacturing technology and related intangibles had independent significance and thus should be examined separately; and if so, whether the Tax Court committed clear error in valuing (2) the transfer price for the lenses and (3) the royalty rate for the intangibles. Preliminarily, however, we summarize the applicable regulations, which are "binding on the Commissioner." *United States Steel Corp. v. Commissioner*, 617 F.2d 942, 947 (2d Cir. 1980); see *Lansons, Inc. v. Commissioner*, 622 F.2d 774, 776-77 (5th Cir. 1980).

A. The Regulatory Background.

The Commissioner has adopted regulations implementing section 482 that are pivotal to the decision of this case. First, as to the transfer price for lenses, Treas. Reg. 1.482-2(e)(1) provides that in the event of a transfer of tangible property between commonly controlled entities

> at other than an arm's length price . . . the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

Id. Treas. Reg. § 1.482-2(d)(1) and (2), which deals with transfers of intangible property between commonly controlled entities, provides an essentially identical rule applicable to the royalty paid by B & L Ireland for the use of B & L's intangibles.

Section 1.482-2(e) goes on to specify particular methods to deal with the transfers of tangible property, to wit:

1) The comparable uncontrolled price method relies upon the price prevailing in comparable sales between entities that are not members of the same control group. § 1.482-2(e)(2).

2) The resale price method starts with the price which the buyer in the controlled sale is anticipated to charge upon resale to an entity outside the control group; that resale price is then reduced by the profit markup of a comparable uncontrolled buyer/reseller. § 1.482-2(e)(3).

3) The cost plus method adds to the cost of producing the subject property a markup equal to the profit percentage of a comparable uncontrolled seller.

§ 1.482-2(e)(4).

These methods must be applied sequentially. That is, "if there are comparable uncontrolled sales . . . the comparable uncontrolled price method must be utilized because it is the method likely to result in the most accurate estimate of an arm's-length price . . . ." § 1.482-2(e)(1)(ii). "If there are no comparable uncontrolled sales, then the resale price method must be utilized if the standards for its application are met . . . ." *Id.* If not, either the resale price method or cost-plus method may be used, "depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's-length price." *Id.* If the standards for applying one of the three methods are met, that method must be utilized "unless the taxpayer can establish that, considering all the facts and circumstances, some [other] method of pricing . . . is clearly more appropriate." § 1.482-2(e)(1)(iii). If however, none of the three methods can reasonably be applied in a given case, "some appropriate method of pricing other than those described . . . or variations on such methods, can be used." *Id.*

The general theory of the cited regulations, as well as the others promulgated by the Commissioner to implement section 482, is to treat each of the individual members of a commonly controlled group as a separate entity, transactions between which are taxable events to be conformed to the economic realities that would obtain between independent economic entities conducting the identical transactions at arm's-length. See *Commissioner v. First Sec. Bank*, 405 U.S. 394, 400 & n.10, 31 L. Ed. 2d 318, 92 S. Ct. 1085 (1972) (quoting Treas. Reg. 1.482-1(b)(1) (1971)); Note, Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code, 89 *Harv. L. Rev.* 1202, 1205, 1209 (1976) ("Note"). This contrasts with the alternative theoretical model, the unitary entity theory, which considers all commonly controlled entities as "parts of the same unitary business," with the result that "intercompany transactions cannot produce a real economic profit or loss and must therefore be eliminated from tax consideration." Note at 1206.

We now turn to the issues addressed by the Tax Court.

B. Independent Significance of Transfer Price and Royalty Rate.

The Tax Court framed this issue in the following terms:

As a preliminary matter, we must first address [the Commissioner's] contention that it is inappropriate to analyze the transfer price and royalty rate used by B & L separately, on the theory that B & L and B & L Ireland would have constructed their relationship in a different manner had they been conducting their affairs at arm's length. [The Commissioner] argues that B & L would never have agreed to license its spin cast technology which allowed it to produce soft contact lenses for approximately $1.50 per lens and then purchase lenses from the licensee for

> $7.50 per lens. [The Commissioner] argues that B & L would have been unwilling to pay an independent third party much more than its costs would have been had it chosen to produce the contact lenses itself. [The Commissioner] is indifferent as to whether the royalty is increased or the transfer price is decreased as long as the result is that B & L Ireland receives only its costs of production and a reasonable mark up. In essence, [the Commissioner] argues that B & L Ireland was little more than a contract manufacturer the sale of whose total production was assured and who thus was not entitled to the return normally associated with an enterprise which bears the risk as to the volume of its product it will be able to sell and at what price.

92 T. C. at 583.

In essence, [the Commissioner] argues that B & L Ireland was little more than a contract manufacturer the sale of whose total production was assured and who thus was not entitled to the return normally associated with an enterprise which bears the risk as to the volume of its product it will be able to sell and at what price.

The Commissioner's position is not without force. It failed, however, to persuade the Tax Court, which concluded that B & L was not committed to purchase the entire output of B & L Ireland, and that B & L Ireland accordingly should not be considered a contract manufacturer entitled only to a modest markup on its manufacturing costs. 92 T.C. at 584; see also *Eli Lilly & Co.*, 856 F.2d at 863-64 & n.9 (rejecting Commissioner's "contract manufacturer" contention); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 373 (1987) (same). The Tax Court further noted that B & L Ireland was not guaranteed a continuing $7.50 resale price, and that the price declined to $6.50 in 1983 as a result of market pressures. 92 T.C. at 584. It is undoubtedly true, as the Commissioner contends, that B & L was in a general sense committed to the success of B & L Ireland. We nonetheless find no clear error in the Tax Court's conclusion that:

> The most that can be said is that B & L Ireland had certain expectations as to the volume and price of lenses it could anticipate selling to B & L or its affiliates. However, such expectations are no different than those which any supplier has with regard to the business of a major customer and do not constitute a guarantee which effectively insulated B & L Ireland from market risks.

Id.; accord, *Sundstrand Corp. v. Commissioner*, 96 T.C. No. 12, slip op. at 187 (Feb. 19, 1991).

Furthermore, the structure of the Commissioner's regulations argues against the "contract manufacturer" thesis advanced by the Commissioner. The allowance of a markup of production costs, as the contract manufacturer theory postulates and as the Commissioner's notice of deficiency in this case explicitly provided (D.A. 74), is simply an application of the cost-plus method provided in the Commissioner's regulations. See Treas. Reg. § 1.482-2(e)(4). Those regulations explicitly provide, however, that the comparable uncontrolled price method is to be utilized, in preference to the cost-plus method, if the conditions for application of the former method are satisfied. See Treas. Reg. § 1.482-2(e)(1)(ii). Since, as will hereinafter appear, we find those conditions to be fulfilled in this case, we are accordingly constrained by section 1.482-2(e)(1)(ii) to reject the Commissioner's contention that B & L Ireland should be treated as a contract manufacturer.

We therefore proceed to independent consideration of the Tax Court's treatment of the transfer price paid by B & L for the lenses manufactured by B & L Ireland, and the royalty rate paid by B & L Ireland to B & L for the use of B & L's intangibles.

C. Transfer Price for Lenses.

The Commissioner contends that the Tax Court erred in finding that the standards for the comparable uncontrolled price method were met. That method must be applied if, but only if, comparable uncontrolled sales are available. Treas. Reg. § 1.482-2(e)(1)(ii). The Commissioner focuses on the meaning of the term "comparable," on which the regulations elaborate as follows:

> Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price.

Id. § 1.482-2(e)(2)(ii).

The Tax Court premised its ruling upon numerous sales by four different lens manufacturers to unrelated lens distributors. All comparable sales prices were reduced by $0.62, an adjustment that compensated for B & L's unique practice of paying the duty and freight charges on its lens purchases. After this adjustment, all these sales were at a price that exceeded the $7.50 transfer price paid by B & L, with one exception. One manufacturer, the Amsco/Lombart division of the American Sterilization Company, transacted some sales (less than half) that, when adjusted, indicated a transfer price less than $7.50, but the Tax Court gave these sales little weight because, unlike the uniform price charged by B & L Ireland, they set different prices for standard and thin lenses. All other adjusted comparable sales, including Amsco/Lombart single price sales, indicated a transfer price above $7.50, with many exceeding $10.00.

The Tax Court's conclusion that these sales were comparable was premised on findings of fact that B & L functioned as a distributor with respect to the lenses it purchased from B & L Ireland, and that the soft contact lenses at issue were generally considered a fungible commodity. The Commissioner disputes the former finding. He contends that in addition to its distribution functions, B & L "supplied the know-how necessary to manufacture the lenses, the Bausch & Lomb and Soflens trademarks, the FDA approval required for sales on the United States market, the fruits of its ongoing research and development, and ready-made foreign and domestic markets."

We find this argument unconvincing. As was implicit in our prior determination that the transfer price for lenses and royalty rate for intangibles should be accorded independent consideration, the provision of know-how, trademarks, FDA approval, and ongoing research and development is properly taken into account hereinafter with respect to the royalty to be imputed to B & L Ireland on an arm's length basis for the transfer of these intangibles. Further, the provision of ready made markets is entirely consistent with the role of a distributor.

The position urged by the Commissioner would preclude comparability precisely because the relationship between B & L and B & L Ireland was different from that between independent buyers and sellers operating at arms length. This, however, will always be the case when transactions between commonly controlled entities are compared to transactions between independent entities.

We addressed a similar contention by the Commissioner in *United States Steel Corp. v. Commissioner*, 617 F.2d 942 (2d Cir. 1980). The Commissioner there argued that identically priced shipping services supplied to competitors of United States Steel by its subsidiary were not comparable to the services supplied by the subsidiary to United States Steel because of the special parent/subsidiary relationship that existed between them. We responded that the Commissioner's approach might "recognize economic reality; but . . . [would] also . . . engraft a crippling degree of economic sophistication onto a broadly drawn statute, which — if 'comparable' is taken to mean 'identical', . . . — would allow the taxpayer no safe harbor from the Commissioner's virtually unrestricted discretion to reallocate." *Id.* at 951.

Similarly, the position urged by the Commissioner herein amounts to reading so broadly the requirement in Treas. Reg. § 1.482-2 (e)(ii) that the "circumstances involved" in comparable uncontrolled sales and controlled sales under section 482 review be "identical," or "nearly identical," as to threaten effective nullification of the comparable uncontrolled price method. That method is postulated in the Commissioner's regulations, however, as the method of choice for testing transfers of tangible property between commonly controlled entities. We therefore decline to adopt the suggested interpretation of section 1.482-2(e)(ii).

D. The Royalty Rate for B & L's Intangibles.

The relevant regulation provides two methods for determining an arm's-length price for the transfer or use of intangible property. If the transferor has made similar transfers to unrelated parties, "the amount of the consideration for such transfers shall generally be the best indication of an arm's-length consideration." § 1.482-2(d)(2)(ii). In the absence of an adequately similar transaction, the arm's length consideration may be determined with reference to a lengthy list of applicable factors. § 1.482-2(d)(2)(iii).

The 1981 licensing agreement provided that B & L Ireland would pay royalties to B & L in the amount of five percent of B & L Ireland's total sales. Conceding that this royalty was unreasonably low, B & L presented expert opinions at trial that an arm's length consideration would have been five percent of the average price realized by B & L and its subsidiaries upon the sale of the lenses to unrelated third parties ("ARP"). The Commissioner's experts calculated a much higher rate, between twenty-seven and thirty-three percent of ARP.

The Tax Court rejected the positions presented by both parties' experts. Concluding that there were no sufficiently similar transactions upon which to base an arm's length rate, the court focused on two of the factors listed in the applicable regulation: the "prospective profits to be realized . . . by the transferee through its use . . . of the property," and the "capital investment and starting up expenses required of the transferee." § 1.482-2(d)(2)(iii)(g) and (h). The court relied primarily upon a proposal made by B & L to the IDA in early 1980, related internal B & L projections, and especially a Special Expenditure Application ("SEA") submitted to B & L management on October 15, 1980 with respect to the Waterford facility as the best indications of (1) the profits that an independent entrepreneur would anticipate from the use of spin cast technology, and (2) the capital investment required to generate those profits.

The Tax Court made two adjustments to the SEA projections in order to reflect the approach of a "prudent investor" in the circumstances. First, the court reduced the projected output at the Waterford facility during the years 1986 through 1989 to account for anticipated "erosion in the demand for both standard and thin lens sales as prolonged wear lenses made of new materials became available." Second, the court made reductions in projected transfer prices for 1983 and beyond on the basis that lower cost competitors would enter the market and drive down prices.

Reasoning that the purpose of a licensing agreement is to divide the profits attributable to use of the licensed intangibles, the Tax Court then reached the following determination:

> Using our best judgment, we find that at arm's length B & L Ireland would have been willing to invest in the lens production facility even if required to share approximately 50 percent of the profits therefrom with B & L as consideration for use of its intangibles . . . . This equates to a royalty rate of 20 percent of [B & L Ireland's] net sales.

92 T.C. at 611; cf. *G.D. Searle & Co.*, 88 T.C. at 376 (royalty rate determined on basis of court's "best judgment based on a consideration of the entire record before [it]"); *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172, 236 (1985) (same).

[T]he Tax Court was entitled to conclude that "what later transpired in no way detracted from the reasonableness of the agreement when it was made."

In response to this analysis, the Commissioner contends that the SEA projections did not correspond to the actual experience of the parties because: (1) the Waterford facility ended up with greater manufacturing capacity than the projections had assumed; and (2) a decision was made in late 1981 for that facility to maximize lens production by producing for the United States market, whereas the SEA projections assumed production primarily or exclusively for foreign markets. Since the license agreement between B & L and B & L Ireland was terminable at will, the Commissioner contends, B & L would have scrapped the agreement, if dealing at arm's length with an independent party, and insisted upon the negotiation of new terms.

We are not persuaded. Considerable deference to the Tax Court's evaluation of trial evidence, and especially expert testimony, is appropriate in appellate review of this sort of complex factual determination. See *Eli Lilly & Co.*, 856 F.2d at 872. Here, as in *R.T. French Co. v. Commissioner*, 60 T.C. 836 (1973), another case involving section 482 reallocation of royalties paid to a foreign affiliate, the Tax Court was entitled to conclude that "what later transpired in no way detracted from the reasonableness of the agreement when it was made." *Id.* at 852.

It is true that in *R.T. French Co.* the agreement had a fixed term, see id., whereas here the agreement between the parties was terminable at will. We regard this as too thin a foundation, however, for the Commissioner's argument that B & L would surely have terminated the agreement and negotiated new terms if dealing with an independent licensee, at least in the absence of a fuller record as to the manufacturing alternatives available to B & L at the time it was decided to increase lens production at B & L Ireland. Cf. *Sunstrand Corp.*, slip op. at 169 (rejecting ready availability of alternative source of manufacture in view of specialized manufacturing know-how required to produce complex avionic device). Accordingly, we perceive no basis to reject the Tax Court's carefully considered determination as clearly erroneous.

Conclusion

The decision of the Tax Court is affirmed.

Questions

1. Why did the court in *Bausch & Lomb* give great weight to the fact that the parent company is not obligated to purchase the output of its affiliate? Would a contract imposing such an obligation on Bausch & Lomb have any economic substance? How do the 1994 regulations treat such contract issues? See Reg. § 1.482-1(d)(3)(ii)(B)(*1*) (1994) ("If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms. . . ." Consider also the following quotation from Reg. § 1.482-1(d)(3)(ii)(B)(*2*) (1994):

> In the absence of a written agreement, the district director may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights. . . . 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.

Do you suspect that this language is directed at closing the *Bausch & Lomb* barn door? How would you advise Bausch & Lomb to deal with its Irish affiliate for post-1994 years?

2. If Bausch & Lomb had decided to contract with an unrelated company to manufacture the soft contact lenses, it almost certainly would not have paid that company the amounts deflected to B&L Ireland. The Commissioner contended, quite plausibly, that Bausch & Lomb would have paid an unrelated manufacturer its reasonable costs plus some modest markup. Even if the court in *Bausch & Lomb* had accepted the Commissioner's premise, however, it probably would have had difficulty deciding for the government on the government's "contract manufacturer" theory in that the 1968 regulations gave no support for that approach.

The 1994 regulations give some support for the contract manufacturer theory, but that support is muted. Would the following language in Reg. § 1.482-1(f)(2)(ii) (1994) justify treating B&L Ireland in *Bausch & Lomb* as a contract manufacturer and applying a cost-plus method to its sales to Bausch & Lomb?

> 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.

3. Consider also the following example contained in Reg. § 1.482-4(d)(2) (1994). What effect on the *Bausch & Lomb* case if the quoted regulatory language were in effect at the time the case was decided?

> *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 section 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.

Why do you suppose the regulation writers were unwilling to give the Service the specific authority to treat an affiliate such as B&L Ireland as a contract manufacturer for the parent corporation that established it? What is the difference between actually restructuring a transaction and using the possibility of an alternative transaction as a factor in determining whether or not a price is an arm's length price?

4. The courts have long acknowledged that they are required to give a presumption of correctness to a determination by the Commissioner and that they are to overturn a determination only on a finding that the determination was "arbitrary, capricious, or unreasonable." Did the Tax Court give that presumption of correctness to the determination of the Commissioner in *Bausch & Lomb*? The Tax Court's own determination was itself somewhat arbitrary — it apparently reverse engineered an "arm's length" royalty rate that would provide about a 50/50 split of the profits between Bausch & Lomb and its Ireland affiliate. The Second Circuit was willing to indulge a presumption of correctness to the determination of the Tax Court. Given the difficulties of proving an arm's length price, the person who is presumed to be correct gets to set that price. Does it make sense, therefore, for the Tax Court rather than the Commissioner to enjoy the presumption of correctness?

5. Assume that the government had won *U.S. Steel* and *Bausch & Lomb* and that the penalty set forth in Code section 6662(e) for a "substantial valuation misstatements" had been in effect at that time. Would the IRS have been able to impose that penalty on either U.S. Steel or Bausch & Lomb? What if those cases arose in years in which the 1994 regulations were in effect and the government then won its case?

6. Is the tax avoidance illustrated in *Bausch & Lomb* blocked by the subpart F rules? Note that income earned by B & L Ireland is characterized as business income. Would it matter if the income were characterized as royalty income? Should tax avoidance of the type illustrated by the subject of the anti-avoidance rules of subpart F?