

## LB&I International Practice Service Transaction Unit

|             |       |  |             |         |
|-------------|-------|--|-------------|---------|
| Shelf       |       | Business Inbound                               |             |         |
| Volume      | 6     | Inbound Income Shifting                        | UIL Code    | 9422    |
| Part        | 6.7   | Sales or Leases of Tangible Property/Goods     | Level 2 UIL | 9422.07 |
| Chapter     | 6.7.1 | Sales or leases of Tangible Property - Inbound | Level 3 UIL | N/A     |
| Sub-Chapter | N/A   | N/A  |             |         |

|                  |   |
|------------------|---|
| <b>Unit Name</b> | Purchase of Tangible Goods from a Foreign Parent – CUP Method |
|------------------|---|

|                               |                      |
|-------------------------------|----------------------|
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## Issue and Transaction Overview

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

Foreign Parent Companies (“FPs”) will manufacture products, either directly or via a controlled entity, for sale into the United States. This might be accomplished through a US wholly-owned Subsidiary (“USS”), which acts as a wholesale distributor. In such cases, the USS will purchase the tangible goods primarily for subsequent resale in the U.S. market.

Sales of tangible goods between controlled entities are subject to transfer pricing principles.

The sales price FP charges USS should be arm’s length. If the price FP charges USS is more than an arm’s length price, then income is shifted from USS to FP. This may result in USS paying lower US taxes than required.

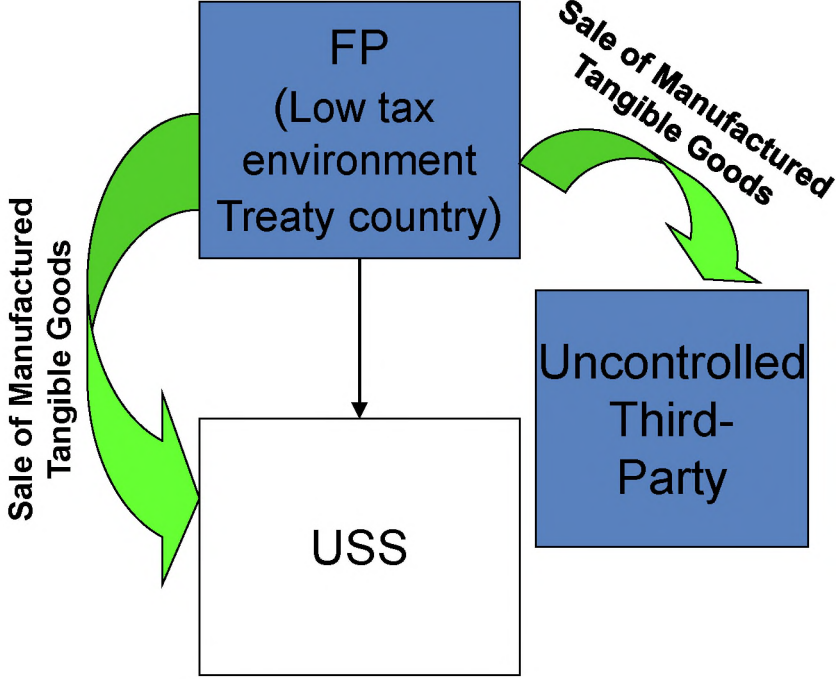
Both the Service and Taxpayers must use the best or most reliable method when performing a transfer pricing analysis. One such method is the Comparable Uncontrolled Price (“CUP”) method. The CUP method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

In this example, we are using a FP that enjoys a low tax environment

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## Transaction and Fact Pattern

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

| Diagram of Transaction  | Facts   |
|---|---|
|  <p>The diagram illustrates the transaction flow. At the top is a blue box labeled 'FP (Low tax environment Treaty country)'. Below it is a white box labeled 'USS'. To the right is another blue box labeled 'Uncontrolled Third-Party'. A green arrow points from the FP box to the USS box, with the text 'Sale of Manufactured Tangible Goods' written vertically to its left. Another green arrow points from the FP box to the Uncontrolled Third-Party box, with the text 'Sale of Manufactured Tangible Goods' written diagonally above it. A third green arrow points from the Uncontrolled Third-Party box to the USS box, with the text 'Sale of Manufactured Tangible Goods' written vertically to its left. A straight black arrow points from the FP box down to the USS box.</p> | <ul style="list-style-type: none"> <li>▪ FP wholly owns USS.</li> <li>▪ FP is a tax resident in a treaty country where it enjoys a low tax environment.</li> <li>▪ FP manufactures and sells tangible goods to USS.</li> <li>▪ USS, a wholesale distributor, includes these purchases from FP in “cost of goods sold,” which affects its gross profit and net income.</li> <li>▪ FP also sells the same or similar manufactured finished goods to uncontrolled third parties.</li> <li>▪ The uncontrolled third parties may either be retailers or wholesale distributors which sell the goods in other markets generally outside the U.S.</li> </ul> |

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## Effective Tax Rate Overview

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### ETR of Company

#### ETR Impact of Adjustment

- If the transfer price for tangible goods charged by the FP to the USS is too high, then the cost of goods sold reported by the USS will be higher than appropriate, reducing the US taxable income. Conversely, the FP sales revenue will be higher than appropriate, increasing the FP's income. This effectively shifts income reported from the USS to the low-tax FP.
- The reduction in the worldwide tax expense is the difference between the higher US rate and the lower foreign country tax rate, as applied to the excess profits amount. This reduction also lowers the corporation's ETR.
- An adjustment to decrease the transfer price charged by the FP to USS would shift more profits back to the US resulting in a higher ETR.

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## Summary of Potential Issues

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

|                                |   |
|--------------------------------|---|
| <a href="#"><u>Issue 1</u></a> | Are the controlled and uncontrolled transactions comparable?  |
| <a href="#"><u>Issue 2</u></a> | Can reliable adjustments be made to account for any differences between the controlled and uncontrolled transactions? |

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## All Issues, Step 1: Initial Factual Development

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

Taxpayers may use transfer prices on sales of tangible goods to shift income outside the United States. It is important to establish the facts and supporting documentation to determine whether the CUP method is the best method in establishing an arm's length intercompany price.

| Fact Element  | Resources  | 6103 Protected Resources |
|---|--|--------------------------|
| <ul style="list-style-type: none"> <li>Does the tax return reflect purchases of tangible goods from foreign controlled entities?</li> </ul>   | <ul style="list-style-type: none"> <li>Form 5472, Purchase Stock-in-Trade</li> </ul>   |                          |
| <ul style="list-style-type: none"> <li>Why was the CUP method either selected or rejected?</li> </ul>   | <ul style="list-style-type: none"> <li>Transfer Pricing Studies</li> </ul>   |                          |
| <ul style="list-style-type: none"> <li>What type of goods are being sold by FP to USS?</li> <li>Are the same or similar goods being sold by FP to uncontrolled parties?</li> <li>Is there indirect evidence of comparable uncontrolled transactions?</li> </ul> | <ul style="list-style-type: none"> <li>Taxpayer's Web-site</li> <li>Catalog / Product Literature</li> <li>Functional Analysis</li> <li>Intercompany Agreements</li> <li>Invoices</li> <li>Taxpayer Interviews</li> <li>Public exchanges/Quotation Mediums</li> </ul> |                          |



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## Issue 1, Step 2: Review Potential Issues

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### Issue 1



Are the controlled and uncontrolled transactions comparable?

| Explanation of Issue  | Resources  | 6103 Protected Resources |
|---|--|--------------------------|
| <p>Using CUP as the Best Method requires that the taxpayer identify goods for sale in uncontrolled transactions (i.e., those with unrelated third parties) that are the same or similar to the goods being sold in their controlled transaction.</p> <p>The degree of comparability between controlled and uncontrolled transactions is determined by evaluating all factors that could affect prices (e.g., Functions performed, Risks assumed, Contractual terms, Economic conditions, and Property or services).</p> <p>Indirect evidence of a CUP may be derived from data from public exchanges or quotation media, but only if the requirements in the regulations are met.</p> | <ul style="list-style-type: none"> <li>▪ <a href="#">Treas. Reg. 1.482-3(b)(2)(ii)</a></li> <li>▪ <a href="#">Treas. Reg. §1.482-1(d)</a></li> <li>▪ <a href="#">Treas. Reg. 1.482-3(b)(5)</a></li> <li>▪ IPS Unit – Comparability Analysis for Tangible Goods Transactions Inbound, DCN: ISI/9422.07_01 thru _06(2013)</li> </ul> |                          |
|  <p><b>DECISION POINT:</b> Are substantially the same products being sold under substantially the same circumstances in both the controlled and uncontrolled transactions?</p>  | <ul style="list-style-type: none"> <li>▪ <a href="#">Treas. Reg. 1.482-3(b)(2)</a></li> </ul>  |                          |
|  <p><b>TREATY IMPLICATION:</b> Tax treaty implications for withholding tax issues might be in order for payments which are considered in excess of arm's length and deemed to be dividends.</p>   | <ul style="list-style-type: none"> <li>▪ Refer to Specific United States – Foreign Parent Country Income Tax Treaty</li> <li>▪ Contact Tax Treaty IPN</li> </ul>   |                          |



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## Issue 1, Step 3: Additional Factual Development

| Purchase of Tangible Goods from a Foreign Parent – CUP Method  |  |                          |
|--|--|--------------------------|
| Issue 1  |  |                          |
| Are the controlled and uncontrolled transactions comparable?   |  |                          |
| Fact Element   | Resources  | 6103 Protected Resources |
| <ul style="list-style-type: none"> <li>▪ Are the tangible goods in the controlled and uncontrolled transactions sufficiently similar? Are there differences in the physical characteristics or quality of the goods?</li> <li>▪ Is the comparable price based on actual transactional data or average prices?</li> </ul> | <p><i>Request and/or Review the following:</i></p> <ul style="list-style-type: none"> <li>▪ Transfer Pricing Studies</li> <li>▪ Invoices</li> <li>▪ Catalog / Product Literature</li> <li>▪ Contracts</li> <li>▪ Industry studies</li> </ul> |                          |
|  <b>CONSULTATION:</b> You should consult with an Economist or Engineer to determine if the products are the same or similar.   |  |                          |
|  <b>CONSULTATION:</b> You may want to consult with a CAS to analyze computer-based sales records.   |  |                          |

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## Issue 1, Step 3: Additional Factual Development (cont'd)

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### Issue 1

Are the controlled and uncontrolled transactions comparable?

| Fact Element   | Resources  | 6103 Protected Resources |
|--|--|--------------------------|
| <ul style="list-style-type: none"> <li>▪ Are there additional differences in terms and conditions of the sale in the controlled and uncontrolled transaction? Review the resources listed here for differences such as :               <ul style="list-style-type: none"> <li>– intangible assets (e.g., brand names)</li> <li>– provision of services</li> <li>– date of the transaction</li> <li>– foreign currency risk</li> <li>– inventory risk</li> <li>– level of market</li> <li>– geographic market</li> <li>– warranty terms</li> <li>– purchase/sales volume</li> <li>– credit terms</li> <li>– transportation terms</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>▪ Transfer Pricing Studies</li> <li>▪ Contracts / Invoices</li> <li>▪ Intercompany Agreements</li> <li>▪ Annual Reports</li> <li>▪ Product Literature</li> <li>▪ <u>Transfer Pricing Roadmap</u></li> <li>▪ Website research</li> <li>▪ Geographic Economic Surveys</li> <li>▪ SEC Reports – check for geographic market comments, product description, notes on competitors, and advantages of taxpayer that might suggest intangibles present</li> <li>▪ <u>IRM 4.61.3.4.5 – How to Develop a Section 482 Case</u>– Transfers of Tangible Property</li> </ul> |                          |


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## Issue 1, Step 4: Develop Arguments

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### Issue 1

Are the controlled and uncontrolled transactions comparable?

| Explanation of Approach  | Resources   | 6103 Protected Resources |
|--|---|--------------------------|
| <p>To establish that the controlled and uncontrolled transactions are truly comparable, you need to conduct an in-depth review of the factors discussed in Treas. Reg. 1.482-3(b)(2)(ii)(B) and other differences you have identified. For example, some potential differences may be terms of sale or similarity of warranties.</p> <p>If a CUP is found to exist but not selected as the Best Method to evaluate the arm's length price, why was the CUP method not selected? Generally, a CUP is the most direct and reliable measure of an arm's length price.</p> | <p><u>Treas. Reg. 1.482-3</u></p> <ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.482-3(b)(2)</li> <li>▪ Treas. Reg. 1.482-3(b)(2)(ii)(A)</li> <li>▪ Treas. Reg. 1.482-3(b)(2)(ii)(B)</li> </ul> |                          |
| <p> <b>DECISION POINT:</b> If USS selected the CUP method and differences with the controlled transaction that would affect the price are found, can such differences be adjusted for?</p>   |   |                          |


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## Issue 2, Step 2: Review Potential Issues

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### Issue 2

Can reliable adjustments be made to account for any differences between the controlled and uncontrolled transactions?

| Explanation of Issue   | Resources   | 6103 Protected Resources |
|--|---|--------------------------|
| <p>The results derived from applying the CUP method generally will be the most reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made.</p> <p>For example, the presence of embedded intangibles in any of the transactions (either controlled or uncontrolled) would likely be considered a material difference. In this event, since material differences cannot be reliably adjusted, the CUP method is unlikely to provide a reliable measure of the arm's length price.</p> | <ul style="list-style-type: none"> <li>▪ <a href="#">Treas. Reg. 1.482-3(b)(2)(ii)</a></li> <li>▪ <a href="#">Treas. Reg. 1.482-3(b)(4)</a></li> <li>▪ <a href="#">Treas. Reg. §1.482-1(d)(3)</a></li> <li>▪ IPS unit Computing Adjustments to Comparable Transactions (To be developed)</li> </ul> |                          |
|  <p><b>CONSULTATION:</b> You should consult with an economist and/or engineer to determine whether adjustments can be made to account for differences between the controlled and uncontrolled transactions.</p>  |   |                          |

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## Issue 2, Step 3: Additional Factual Development

| Purchase of Tangible Goods from a Foreign Parent – CUP Method   |  |                          |
|---|--|--------------------------|
| Issue 2   |  |                          |
| Can reliable adjustments be made to account for any differences between the controlled and uncontrolled transactions?   |  |                          |
| Fact Element  | Resources  | 6103 Protected Resources |
| <ul style="list-style-type: none"> <li>▪ If there are differences between the controlled and uncontrolled transactions:               <ul style="list-style-type: none"> <li>– Can these differences be quantified reliably, and can adjustments be made to make the transactions truly comparable?</li> <li>– Is the data used to make the adjustments reliable?</li> <li>– Are the assumptions used to make the adjustments sound and reasonable?</li> <li>– Are there additional adjustments which have not been identified? Can these be quantified?</li> </ul> </li> </ul> | <p><i>Request and/or Review the following:</i></p> <ul style="list-style-type: none"> <li>▪ Organizational charts</li> <li>▪ Transfer Pricing Studies</li> <li>▪ Contracts</li> <li>▪ Intercompany Agreements</li> <li>▪ Invoices</li> <li>▪ Annual Reports</li> <li>▪ Product Literature</li> <li>▪ Website research</li> </ul> |                          |

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## Issue 2, Step 4: Develop Arguments

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### Issue 2

Can reliable adjustments be made to account for any differences between the controlled and uncontrolled transactions?

| Explanation of Approach   | Resources  | 6103 Protected Resources |
|---|--|--------------------------|
| <p>When there are differences in the products or circumstances of sale, the CUP method requires that such differences either have no effect on price, or if such differences are minor and have a definite and reasonably ascertainable effect on price, then appropriate adjustments must be made.</p> <p>Deficiencies in data or assumptions diminish the applicability of a CUP method since reliance on comparability of the controlled and uncontrolled transaction is reduced. The reliability of the CUP method increases as the completeness and accuracy of the data and assumptions increase.</p> | <ul style="list-style-type: none"> <li>▪ <u>Treas. Reg. 1.482-3(b)(2)(ii)</u></li> </ul> |                          |

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## Issue 2, Step 4: Develop Arguments (cont'd)

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### Issue 2

Can reliable adjustments be made to account for any differences between the controlled and uncontrolled transactions?

| Explanation of Approach   | Resources   | 6103 Protected Resources |
|---|---|--------------------------|
| <ul style="list-style-type: none"> <li>▪ For examples of making adjustments to a CUP to determine an arms-length price see <i>Eli Lilly &amp; Co. v. Comr.</i></li> <li>– Differences between the controlled and uncontrolled transactions that could be reliably quantified included provision of certain raw materials, credit terms, free samples, and certain differences in quality. The court agreed that these adjustments should be made, but disagreed with the amounts.</li> <li>– Differences between the controlled and uncontrolled transactions that could not be reliably quantified included provision of packaging equipment, quality control, and the value of a patented compound incorporated into a comparable product. The court did not allow these adjustments to be made.</li> </ul> | <ul style="list-style-type: none"> <li>▪ <i>Eli Lilly &amp; Co. v. Comr.</i>, 84 T.C. 996 1168-86 (1985), <i>aff'd in part and rev'd in part</i>, 856 F.2d 855 (7<sup>th</sup> Cir. 1988).</li> </ul> |                          |


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## Issue 2, Step 4: Develop Arguments (cont'd)

### Purchase of Tangible Goods from a Foreign Parent – CUP Method

#### Issue 2

Can reliable adjustments be made to account for any differences between the controlled and uncontrolled transactions?

| Explanation of Approach  | Resources  | 6103 Protected Resources |
|--|--|--------------------------|
| <ul style="list-style-type: none"> <li>▪ Another example of making adjustments to a CUP to determine an arms-length price is found in <i>Compaq Computer Corp. v. Comr.</i> <ul style="list-style-type: none"> <li>– Differences in the <b>physical property</b> between the controlled and uncontrolled transactions that could be reliably quantified included the particular components and time required to process them on the manufacturing line.</li> <li>– Differences in the <b>circumstances of sales</b> between the controlled and uncontrolled transactions that could be reliably quantified included payment terms, advance purchase costs, set-up and cancellation charges, freight, duties, and defective product costs.</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>▪ <i>Compaq Computer Corp. and Subsidiaries v. Comr</i>, T.C. Memo 1999-220.</li> </ul> |                          |
|  <p><b>DECISION POINT:</b> If differences which affect price exist, can adjustments be made to increase the reliability of results? If not, another more reliable method should be considered.</p>   | <ul style="list-style-type: none"> <li>▪ <u>Treas. Reg. 1.482-3(b)(2)(ii)</u></li> </ul>                                       |                          |



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| Type of Resource   | Description(s) and/or Instructions for Accessing   | References   |
| CENTRA sessions  | <ul style="list-style-type: none"> <li>▪ FY2012 Transfer Pricing Introduction to 482.</li> <li>▪ FY2013 IRC 482 Overview. 50767 (HLL028040)</li> </ul>   | <ul style="list-style-type: none"> <li>▪ Transfer Pricing Intro to 482 Overview and Introduction to IRC Sec 482 FINAL with BR 6 revisions.ppt (QRP785958)</li> </ul> |
| Issue Toolkits   | <ul style="list-style-type: none"> <li>▪ IRM 4.61.3-4 Functional Analysis Questionnaire</li> <li>▪ Checklist - IRC 482 Transfer Pricing Case Development Tool</li> <li>▪ <u>IRM 4.61.3.4.5 - How to Develop a Section 482 Case</u></li> <li>▪ <u>IRM 4.43.1.16.1 - Product Pricing by the Controlled Foreign Corporation (CFC) or the Foreign Controlled Corporation (FCC)</u></li> <li>▪ Economists - @ Issue...Adjusted CUP</li> <li>▪ OJT for IES - Development of Transfer Pricing Sec 482 Issues</li> </ul> |  |

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## Training and Additional Resources

### Chapter 6.7.1 Sales or Leases of Tangible Property - Inbound

| Type of Resource         | Description(s) and/or Instructions for Accessing  | References   |
|--------------------------|---|--|
| Podcasts / Videos        | <ul style="list-style-type: none"> <li>FY 11 CPE – Day 2 - Transfer Pricing Track - Risk, Comparability &amp; Best Method.</li> </ul>   | 2011 (TPO) CPE CENTRA - Risk and Comparability (Day 3) |
| Other Training Materials | <ul style="list-style-type: none"> <li>International Examiner Phase III Training, Module E-1, <u>Overview of IRC 482</u></li> <li>International Examiner Phase II Training, Lesson 4, <u>Sales of Tangible Property</u></li> <li><u>Bittker and Lokken, Fundamentals of International Taxation, Chapter 79: Reallocation of Income and Deductions Among Related Taxpayers</u></li> <li><u>OECD Transfer Pricing Guidelines</u></li> </ul> |  |

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## Glossary of Terms and Acronyms

| Acronym | Definition   |
|---------|--|
| CUP     | Comparable Uncontrolled Price                              |
| ETR     | Effective Tax Rate   |
| FP      | Foreign Parent   |
| IBC     | International Business Compliance                          |
| IPN     | International Practice Network                             |
| IRC     | Internal Revenue Code                                      |
| IRM     | Internal Revenue Manual                                    |
| LB&I    | Large Business & International                             |
| OECD    | The Organization for Economic Co-operation and Development |
| TPO     | Transfer Pricing Operations                                |
| UIL     | Uniform Issue List   |
| USS     | A foreign-owned United States subsidiary                   |

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## Index of Related Issues

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| Computing Adjustments to Comparable Transactions | 9411.07           | IPS Unit Coming Soon  |
| Comparable Profits Method (CPM)                  | 9422.07           | IPS Unit – CPM Simple Distributor Inbound, (DCN: ISI/9422.07_07)  |
| Functional Analysis                              | 9422.07           | IPS Unit Coming Soon  |
| Standards of Comparability                       | 9422.07           | IPS Unit – Comparability Analysis for Tangible Goods Transactions Inbound, (DCN: ISI/9422.07_01 thru _06) |
| Resale Price Method (RPM)                        | 9422.07           | IPS Unit: Inbound Resale Price Method Routine Distributor, (DCN: ISI/9422.07_04)                          |
| Rev. Proc. 99-32                                 | 9422.09           | IPS Unit Coming Soon  |
| Arm’s Length Standard                            | 9422.09           | IPS Unit: Arms Length Standard, (DCN: ISI/9422.09_06)   |
| Three Requirements of IRC 482                    | 9422.09           | IPS Unit – Three Requirements of IRC 482, (DCN: ISI/9422.09_02)   |
| Core § 482 Inbound                               | 9422.09           | IPS Unit: Best Method Determination for an Inbound Distributor, (DCN: ISI/9422.09_05)                     |
| MAP Procedural Issues                            | 9450.12           | IPS Unit Coming Soon  |

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