

## LB&I Virtual Library Concept Unit

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| Volume        | 6      | Income Shifting  |
| Part          |        |                  |
| Chapter       |        |                  |
| Subchapter    |        |                  |

|                         |   |                         |
|-------------------------|---|-------------------------|
| <b>Unit Name</b>        | Comparison of the Arm's Length Standard with Other Valuation Approaches - Inbound |                         |
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# Table of Contents

*(View this PowerPoint in “Presentation View” to click on the links below)*

[General Overview](#)

[Relevant Key Factors](#)

[Detailed Explanation of the Concept](#)

[Examples of the Concept](#)

[Index of Referenced Resources](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Practice Units](#)

# General Overview

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

IRC 482 provides the authority for the IRS to make allocations between controlled parties to clearly reflect the income of each party. The arm's length standard is the regulatory standard the IRS has adopted for implementing the clear reflection of income principle for controlled transactions under IRC 482. The regulations under IRC 482 ("Section 482 Regulations") explicitly state that the standard in every case is the arm's length standard:

- In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. (Treas. Reg. 1.482-1(b)(1))

A controlled transaction complies with the arm's length standard if "the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)." Treas. Reg. 1.482-1(b)(1). Compliance with the arm's length standard also requires other considerations, such as realistic alternatives available to the transferor and transferee and whether it would more reliable to consider multiple transactions in the aggregate to determine an arm's length price.

In transfer pricing, the use of valuation methods that don't account for all the considerations that are part of the arm's length standard may result in a non-arm's length price. For example, some taxpayers have used fair market value, fair value, or other valuation approaches, claiming that those are consistent with the Section 482 Regulations and provide arm's length results. Fair market value, fair value, and other valuation approaches may not have the same rules or require the same considerations as the arm's length standard, and thus, may produce prices that are not consistent with arm's length results.

# Relevant Key Factors

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

### Key Factors

Prior to defining the basic principles of the arm's length standard, it is important to understand when IRC 482 applies. IRC 482 allows the IRS to make allocations to ensure that taxpayers clearly reflect income or prevent the evasion of taxes attributable to transactions involving common ownership or control.

Found in the statutory language of IRC 482, there are three basic prerequisites before this code section can be applied:

1. There must be two or more organizations, trades or businesses; AND
2. There must be common ownership or control, either directly or indirectly of such entities; AND
3. The IRS must determine that an allocation is necessary either to prevent evasion of taxes or to clearly reflect the income of any of those entities.

All three prerequisites must be found in order to apply IRC 482. In this concept unit, we are dealing with a controlled transaction between controlled taxpayers. (See Practice Unit on "Three Requirements for IRC 482" listed in the Index of Related Practice Units).

# Facts of Concept

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

### Facts of Concept

#### Realistic Alternatives

Under the arm's length standard, the alternatives realistically available to the transferor and transferee should be considered. This principle assumes that taxpayers are rational and will not choose to enter into an arrangement that makes them worse off economically than another available alternative. Therefore, the fact that the price charged for a controlled transaction is inconsistent with the price of a preferable realistic alternative indicates that the chosen price is not arm's length.

#### Aggregation

Under the arm's length standard, the combined effect of two or more separate transactions may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Treas. Reg. 1.482-1T(f)(2)(i); *Guidant LLC v. Commissioner*, 146 T.C. No.5(2016); *Medtronic Inc. vs. Commissioner*, T.C. Memo 2016-112.



**CONSULTATION:** The arm's length standard can be difficult to apply to some fact patterns. You may wish to consult with legal counsel, Transfer Pricing Practice (TPP), Technical Specialist (TS) or Practice Network (PN) members for assistance in applying these arm's length standard concepts.

# Detailed Explanation of the Concept

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

Common valuation approaches used by taxpayers instead of the arm's length standard

| Analysis  | Resources |
|---|-----------|
| <p>Valuation approaches used by taxpayers include:</p> <ul style="list-style-type: none"> <li>▪ <b>Fair Market Value:</b> The fair market value of an item of property is the price at which the item would change hands between a hypothetical willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. This valuation method does not contemplate a forced sale and requires that fair market value be determined in the market where the item being valued is most commonly sold to the public. See Treas. Reg. 20.2031-1(b) and Treas. Reg. 25.2512-1 for estate and gift tax definitions.</li> <li>▪ <b>Fair Value:</b> Used for financial reporting purposes, the Financial Accounting Standards Board ("FASB") defines fair value in ASC Topic 820-10-35-2 as the "price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction, between market participants, at the measurement date." Used in judicial, regulatory, federal estate/gift tax definitions.</li> </ul> <p>Examples of additional approaches taxpayers may attempt to use in place of the arms length standard could include: use value; owner value; insurable value; collateral value; ad valorem value; intrinsic value; and investment value.</p> |           |

# Detailed Explanation of the Concept (cont'd)

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

Common valuation approaches used by taxpayers instead of the arm's length standard

| Analysis   | Resources |
|--|-----------|
| <p><u>What is the effect of using a valuation approach that does not account for all the considerations applicable to the arm's length standard?</u></p> <p>You may have situations where applying fair market value, fair value, or another valuation approach produces an arm's length result. However, it may be that such valuation approaches will not produce an arm's length result because those valuation approaches have different rules and considerations than the arm's length standard. So, where you see a taxpayer's use of fair market value, fair value, or other valuation approach, you should closely consider whether the application of that valuation approach is consistent with the rules and principles required to comply with the arm's length standard. For example, the treatment of acquisition premiums, discussed next, demonstrates how fair market value may produce a result that is not consistent with the arm's length standard.</p> |           |

# Examples of the Concept

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

### Examples

As shown in the table below, neither fair market value nor fair value (financial reporting) take the same perspective or circumstances as the arm's length standard.

#### Perspective and Circumstances Under Arm's Length Standard Compared to Fair Market Value and Fair Value

| Standard                         | Perspective                           | Circumstances                                     | Defined By                   | Purpose  |
|----------------------------------|---------------------------------------|---|------------------------------|--|
| Arm's Length Standard            | Controlled parties to the transaction | Actual facts of the actual controlled transaction | Section 482 Regulations      | Used in federal income tax matters to determine pre-tax prices for controlled transactions |
| Fair Market Value                | Hypothetical buyer and seller         | Market where item would most commonly be sold     | Statute/Regulations/Case Law | Used in judicial, regulatory, federal estate/gift tax and state tax matters                |
| Fair Value (Financial Reporting) | Hypothetical market participant       | Hypothetical market                               | Accounting Boards            | Used in financial reporting, shareholder dissent, corporate dissolutions, and divorce      |



# Examples of the Concept (cont'd)

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

### Examples

#### Treatment of Acquisition Premium

The stock market is a ready source of equity valuations for publicly-traded companies, and consequently stock prices reflect the value of individual shares to a market of willing buyers and willing sellers. If a publicly-traded company is acquired, the acquiring company may pay an amount greater than the acquired company's pre-acquisition market capitalization measured by the trading price of the acquired company's shares before the acquisition, which is sometimes referred to as "acquisition premium." In this situation, the acquiring firm is willing to pay a higher price than other buyers in the market because, from its perspective and under its specific circumstances, the asset may be worth more to it as a result of:

1. Changing the expected cash flows from the acquired company through control;
2. Changing the overall combined companies' expected cash flows through synergies; and/or
3. Other specific expected benefits.

# Examples of the Concept (cont'd)

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

### Examples

#### Acquisition Premium Under Fair Market Value

When estimating fair market value, the expected cash flows of the actual combined companies may not account for synergies or other specific expected benefits. Under a fair market value standard, the perspective is that of a hypothetical willing buyer and willing seller, and the price they would agree on in the market where the stock would most commonly trade. Consequently, that price would not reflect the expected benefits of a specific buyer or seller to the extent the specific buyer's or seller's expectations differ from those of the hypothetical willing buyer and seller.

#### Acquisition Premium Under Arm's Length Standard

Under the arm's length standard, the appropriate "view" is not what a hypothetical willing buyer or seller would accept as a price, but instead the price the particular transferor and transferee (with all their attendant idiosyncratic facts and circumstances) to the controlled transaction would accept. If a taxpayer acquires a company in an unrelated party transaction at a price above its market-traded share price and shortly thereafter transfers those assets to a controlled taxpayer, then the arm's length price of those assets should generally be determined based on the acquisition price. This is because the acquisition price generally provides the most objective basis and direct evidence of the price that would have been paid between uncontrolled taxpayers for the assets transferred to the controlled taxpayer.

The particular context (e.g., financial reporting, transfer pricing, etc.) determines what standard or valuation approach to apply. In turn, the standard or valuation approach provides the framework for the analysis. For transfer pricing purposes, taxpayers must comply with the arm's length standard.

# Index of Referenced Resources

## Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound

- IRC 482
- Treas. Reg. 1.482-1
- Treas. Reg. 1.482-1T
- *Guidant LLC v. Commissioner*, 146 T.C. No.5 (2016)
- *Medtronic Inc. vs. Commissioner*, T.C. Memo 2016-112

# Training and Additional Resources

| Comparison of the Arm's Length Standard with Other Valuation Approaches – Inbound |   |
|---|---|
| Type of Resource  | Description(s)  |
| SABA Sessions   | <ul style="list-style-type: none"> <li>▪ 2012 (TPO) CENTRA - Overview and Introduction to 482</li> </ul>  |
| Issue Toolkits  | <ul style="list-style-type: none"> <li>▪ IRM 4.61.3 <i>Development of IRC section 482 Cases</i></li> <li>▪ IRM 4.61.3-4 Exhibit, <i>Transfer Pricing Functional Analysis Questionnaire</i></li> <li>▪ IRM 4.61.3.5.1, <i>Functional Analysis</i></li> <li>▪ Audit Tools: Checklist and Audit Tool for Developing Transfer Pricing Issues</li> <li>▪ Audit Tools: Transfer Pricing Road Map</li> </ul> |
| White Papers / Guidance   | <ul style="list-style-type: none"> <li>▪ The White Paper – <i>A Study of Intercompany Pricing Under Section 482 of the Code (1988)</i> Notice 88-123, 1988-2 C.B., 458.</li> </ul>  |
| Other Training Materials  | <ul style="list-style-type: none"> <li>▪ Bittker and Lokken: <i>Fed. Tax'n Inc. Est and Gift</i> Part 10, Chapter 79: Reallocation of Income and Deductions</li> <li>▪ OECD Transfer Pricing Guidelines</li> </ul>  |

# Glossary of Terms and Acronyms

| Term/Acronym | Definition   |
|--------------|--|
| CWI          | Commensurate With Income                                 |
| FASB         | Financial Accounting Standards Board                     |
| FMV          | Fair Market Value  |
| FV           | Fair Value   |
| GAAP         | Generally Accepted Accounting Principles                 |
| OECD         | The Organisation for Economic Co-operation & Development |
| TPO          | Transfer Pricing Operations                              |
| TPP          | Transfer Pricing Practice                                |

# Index of Related Practice Units

| Associated UIL(s) | Related Practice Unit   | DCN   |
|-------------------|---|---|
| 9411              | Commensurate with Income Principle                            | ISO/C/01_02-03 (formerly ISO/CU/V_1_04(2014))         |
| 9411.02-02        | Identifying Foreign Goodwill or Going Concern Value           | ISO/C/01_02_02-02 (formerly ISO/PUO/C_1.2.2_01(2014)) |
| 9411.05           | CPM Simple Distributor Outbound                               | ISO/T/01_05-03 (formerly ISO/9411.05_02(2014))        |
| 9411.05           | Sale of Tangible Goods from a CFC to a USP – CUP Method       | ISO/T/01_05-02 (formerly ISO/9411.05_01(2013))        |
| 9411.07           | Overview of IRC Section 482                                   | ISO/T/01-01 (formerly ISO/9411.07_01(2103))           |
| 9422              | Three Requirements of IRC 482                                 | ISI/P/06-01 (formerly ISI/9422.09_02(2013))           |
| 9422              | Taxpayer’s Affirmative Use of IRC 482                         | ISI/P/06-05 (formerly ISI/9422.09_03(2014))           |
| 9422              | Arm’s Length Standard   | ISI/P/06-03 (formerly ISI/9422.09_06(2013))           |
| 9422.05           | Management Fees   | ISI/T/06_05-01(formerly ISI/9422.05_01(2013))         |
| 9422.07           | Purchase of Tangible Goods from a Foreign Parent - CUP Method | ISI/T/06_07-02 (formerly ISI/9422.07_05(2013))        |
| 9422.07           | CPM Simple Distributor Inbound                                | ISI/T/06_07-04 (formerly SI/9422.07_07(2013))         |