

LB&I International Practice Service Transaction Unit

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Shelf	N/A	Business Outbound	N/A	N/A
Volume	1	Outbound Income Shifting	Level 1 UIL	9411
Part	1.7	Other Transfer Pricing Issues	Level 2 UIL	9411.07
Chapter	1.7.1	Overview of Transfer Pricing Concepts	Level 3 UIL	N/A
Sub-Chapter	N/A	N/A	N/A	N/A

Unit Name	Overview of IRC 482
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Issue and Transaction Overview

Overview of IRC Section 482

Transfer pricing refers to the pricing of transactions between controlled entities. For example, when a US parent (USP) sells a product to its controlled foreign corporation (CFC), IRC 482 requires USP to sell that product at an arm's length price to its CFC. Under IRC 482, controlled entities should price transactions in the same way that uncontrolled entities would under similar circumstances. This is the "arm's length standard", which means that the price of the product that USP charges its CFC should be the same as it would charge to an unrelated party for the same product under similar circumstances.

If the transfer price is not arm's length, the IRS has the authority under IRC 482 to make adjustments by reallocating items of gross income, deductions, credits, or allowances in order to properly reflect income between the entities.

This unit will focus on what is commonly referred to as "outbound transactions." Generally, outbound transactions involve a USP doing business with a foreign controlled entity. While an outbound transaction may involve any type of transaction, this International Practice Service (IPS) unit will focus on the sale of tangible goods to a CFC. Please note that although this Practice Unit discusses the best method rule of an outbound manufacturer, these core concepts also apply to inbound transactions between controlled parties.

It is recommended that the Practice Units: "Three Requirements of IRC 482", DCN: ISI/9422.09_02(2013), and "Arm's Length Standard", DCN: ISI/9422.09_06(2013), also be reviewed with this International Practice Service (IPS) Practice Unit for a better understanding of the arms length standard and best method.

Issue and Transaction Overview (cont'd)

Overview of IRC Section 482

When reviewing the transfer pricing for controlled transactions, it is important to determine how USP selected a transfer pricing method to document that the prices charged to CFC were arm's length. There are various pricing methods available to the USP which are discussed in the regulations promulgated under IRC 482. These include the Comparable Uncontrolled Price (CUP), Resale Price Method, Cost Plus Method, Comparable Profits Method (CPM) and various Profit Split Methods. There is no hierarchy for these methods. However, the taxpayer must select the method that provides the most reliable measure of an arm's length result taking into consideration all the data available. This is known as the "best method rule." In addition, the taxpayer must be able to support the pricing method it selected. One way to determine whether the USP selected the best method is to review its Transfer Pricing Study, if the taxpayer prepared one. The Transfer Pricing Study is the documentation that a taxpayer prepares to show that its transfer pricing was conducted at arm's length.

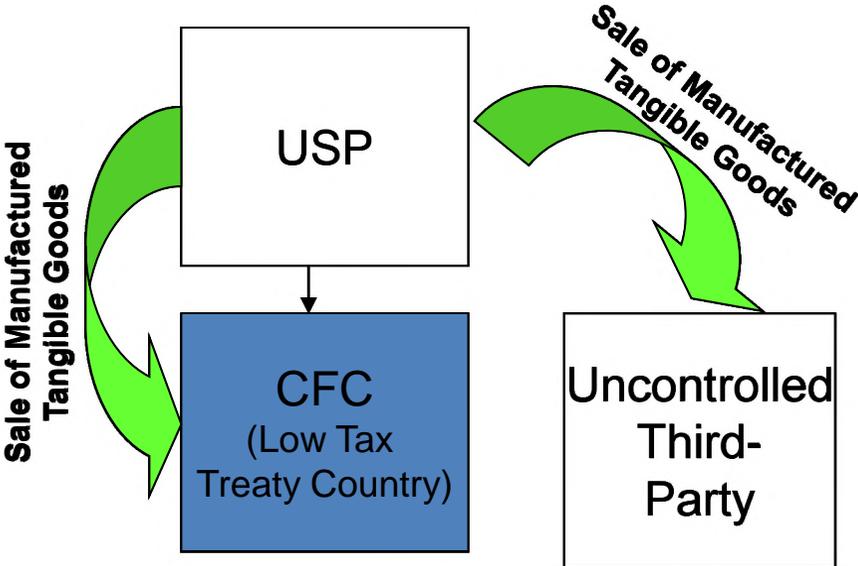
It should be noted that although this Practice Unit uses sales of tangible property to a CFC, this is only one example of when the arms length standard applies. It applies to any and all transactions under IRC 482 including among other things, royalties for the use of intangible property, cost sharing arrangements, loans and advances and related interest, services, use of tangible property, on both outbound and inbound transactions. This Practice Unit discusses a USP with a CFC, therefore, the transaction illustrated is what is commonly referred to as an outbound transaction. Inbound transactions are situations where the taxpayer is a United States Subsidiary (USS) of a foreign parent (FP) corporation.



CONSULTATION: If a valuation adjustment is pursued and gives rise to double taxation, the taxpayer may have access to double tax relief under Article 25 of the US Model Tax Treaty and the Mutual Agreement Process. Make sure you consult with the Advance Pricing and Mutual Agreement (APMA) program.

Transaction and Fact Pattern

Overview of IRC Section 482

Diagram of Transaction	Facts
 <p>The diagram illustrates the transaction flow. At the top is a box labeled 'USP'. Below it is a box labeled 'CFC (Low Tax Treaty Country)'. To the right is a box labeled 'Uncontrolled Third-Party'. A vertical green arrow on the left points from USP down to CFC, labeled 'Sale of Manufactured Tangible Goods'. A green arrow on the right points from USP to Uncontrolled Third-Party, also labeled 'Sale of Manufactured Tangible Goods'. A black arrow points from USP down to CFC.</p>	<ul style="list-style-type: none">▪ USP wholly owns CFC.▪ CFC is incorporated and tax resident in a country that has an income tax treaty with the U.S. based on the U.S. Model treaty.▪ CFC pays tax in the treaty country at a lower tax rate than USP pays in the U.S.▪ USP manufactures goods for sale to distributors, including CFC.▪ USP also sells to uncontrolled third-party distributors. <p>Note: Although this example involves a CFC in a low tax jurisdiction the transaction could also occur with a CFC in a high tax jurisdiction as well.</p>

Effective Tax Rate Overview

Overview of IRC Section 482

ETR of Company

US Corporations establish subsidiaries in low tax jurisdictions not only to increase their worldwide footprint, but also to lower their effective tax rate (ETR). Cross-border pricing is one way a corporation can reduce its overall ETR. In this example, USP may inappropriately shift income to the low tax country CFC by charging less than arm's length prices to CFC. This will lower the company's ETR.

ETR Impact of Adjustment

When USP shifts its income to a lower tax jurisdiction, CFC pays less tax on its profits than USP would pay if it was dealing at arms length. Therefore, the ETR would be significantly lower. If the transfer price is not arm's length, USP's taxable income may decrease while CFC's profits may increase. In this example, when prices charged are below arm's length, income is inappropriately shifted out of the US to the lower tax jurisdiction. An adjustment of the transfer price to arm's length might move income to the US which would generally increase USP's global ETR.

Summary of Potential Issues

Overview of IRC Section 482

Issue 1	Is the transfer pricing method used by USP to document its transfer pricing as arm's length actually the best method?
Issue 2	Did the transfer price meet the arm's length standard?

All Issues, Step 1: Initial Factual Development

Overview of IRC Section 482

Taxpayers may use non arm's length prices for the sale of tangible goods to inappropriately shift income outside of the United States. It is important to establish the facts and review the supporting documentation that substantiates that intercompany prices are charged at an arm's length price.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Does Form 5471 represent that tangible goods were transferred from USP to CFC? 	<ul style="list-style-type: none"> ▪ Form 5471, Schedule M, Lines 1 or 3 (rev. 12-2012) ▪ Transfer Pricing Roadmap ▪ Foreign Payments Practice 	
<ul style="list-style-type: none"> ▪ Did USP have all of the information from the uncontrolled transactions/entities necessary to use the method that it considers to be the best method? ▪ Was USP able to justify the prices charged to CFC for the goods sold at the time of its transfer pricing documentation? ▪ Does there appear to be profit shifting between USP and CFC? ▪ Do the prices charged to CFC reflect risks assumed and the functions performed by CFC and USP? 	<ul style="list-style-type: none"> ▪ Form 1120 and attachments ▪ Transfer Pricing Studies ▪ Organizational Chart ▪ Contracts - Related and Unrelated ▪ Intercompany Agreements ▪ Invoices ▪ Functional Analysis ▪ Taxpayer's Financial Statements – operating profit to sales ratio ▪ Taxpayer's website for information on products, market share, functions performed 	

Issue 1, Step 2: Review Potential Issues

Overview of IRC Section 482

Issue 1

Is the transfer pricing method used by USP to document its transfer pricing as arm's length actually the best method?

Fact Element	Resources	6103 Protected Resources
<p>Parties in a controlled transaction are to use the best method to determine the arm's length price of goods sold between entities. There are transactional-based and profit-based methods. Determining the best method depends on many factors including, but not limited to, the existence of comparable transactions and the degree of similarity of these comparables. Comparables are determined based on the degree of similarity in the functions performed and other factors including risks assumed, contractual terms, economic conditions, and property or services included in the transaction.</p> <p>It is necessary to determine which method USP used to justify its arm's length pricing and understand why it selected that method.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-1(c) ▪ Treas. Reg. 1.482-1(i)(7) ▪ Treas. Reg. 1.482-1(i)(8) 	
<p> DECISION POINT: Remember that different rules apply to different types of transactions. If the issue is for the use of intangible property or provision of services, different regulations will be utilized in the valuing of the transaction.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-4 ▪ Treas. Reg. 1.482-9 	

Issue 1, Step 3: Additional Factual Development

Overview of IRC Section 482

Issue 1

Is the transfer pricing method used by USP to document its transfer pricing as arm's length actually the best method?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Did USP have all available information of uncontrolled transactions/entities to use its best method? ▪ Was USP able to justify the prices charged to the CFC for the goods sold at the time of its transfer pricing documentation? 	<p><i>Request and/or Review the following:</i></p> <ul style="list-style-type: none"> ▪ Organizational Chart ▪ Transfer Pricing Studies ▪ Contracts ▪ Intercompany Agreements ▪ Invoices ▪ Transfer Pricing Roadmap 	
<ul style="list-style-type: none"> ▪ Did the best method that USP selected result in a price charged to CFC that is the same as the price it charged to uncontrolled third parties for the same or similar product sold under similar circumstances? 		

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

Overview of IRC Section 482

Issue 1

Is the transfer pricing method used by USP to document its transfer pricing as arm's length actually the best method?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ What functions does USP perform? What functions does CFC perform? ▪ What functions does the uncontrolled entity perform? ▪ What risks does USP assume? What risks does CFC assume? ▪ What risks does the uncontrolled entity assume? 	<ul style="list-style-type: none"> ▪ Organizational Chart ▪ Transfer Pricing Studies ▪ Contracts ▪ Intercompany Agreements ▪ Invoices ▪ Interview Key Employees ▪ Transfer Pricing Roadmap 	
<ul style="list-style-type: none"> ▪ Did USP analyze the transfer pricing methods that it did not choose, and provide the reasons why those methods were not chosen? ▪ Was there additional information available about the transaction that USP ignored in selecting its transfer pricing method? ▪ Did the taxpayer select correct Standard Industry Codes and North American Industry Classification System entities as comparables? 	<ul style="list-style-type: none"> ▪ Standard Industry Classification and North American Industry Classification System 	

Issue 1, Step 4: Develop Arguments

Overview of IRC Section 482

Issue 1

Is the transfer pricing method used by USP to document its transfer pricing as arm's length actually the best method?

Fact Element	Resources	6103 Protected Resources
<p>The argument for whether USP selected the best method will be determined based on the facts and circumstances of each specific case.</p> <p>When developing a legal analysis to challenge USP's transfer pricing methodology, one must first demonstrate that the transfer pricing method did not reflect an arm's length price. If USP's transfer pricing method is not the best method, one must be able to show that another method is more reliable. Thereafter, one must propose the transfer pricing method that is the best method and be able to verify that it produces an arm's length result using all the information available.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-1(c) ▪ Treas. Reg. 1.482-1(i)(7) ▪ Treas. Reg. 1.482-1(i)(8) 	



DECISION POINT: Determine whether to proceed with this issue based on the results of the best method determination.



CONSULTATION: Consult with an economist regarding the determination of the best method, if necessary.

Issue 2, Step 2: Review Potential Issues

Overview of IRC Section 482

Issue 2

Did the transfer price meet the arm's length standard?

Fact Element	Resources	6103 Protected Resources
<p>Transfer pricing transactions between USP and CFC are reported on Form 5471, Schedule M. All prices between controlled parties must be at arm's length. Arm's length standard is met if the price paid is consistent with the price that would have been paid if uncontrolled entities had engaged in the same transaction under similar circumstances. Examiners should evaluate all available documentation to determine whether the price at which the transaction was reported is similar to the price that would be charged if the entities were not controlled.</p> <p>It is also important to ascertain whether there are other agreements in place or whether other circumstances exist which may impact the price charged in the transaction under consideration.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-1(b) 	

Issue 2, Step 2: Review Potential Issues (cont'd)

Overview of IRC Section 482

Issue 2

Did the transfer price meet the arm's length standard?

Fact Element	Resources	6103 Protected Resources
 <p>DECISION POINT: Based on initial indications, the examiner needs to conduct a risk analysis. Determine whether the potential exists for a material transfer pricing issue and whether or not the issue will be pursued through additional audit steps.</p>	<ul style="list-style-type: none"> ▪ Tax Return ▪ Transfer Pricing Studies 	
 <p>CONSULTATION: Consult with an economist and/or engineer to determine whether you should conduct your own functional analysis in the case where not all functions are properly documented, if necessary.</p>		

Issue 2, Step 3: Additional Factual Development

Overview of IRC Section 482

Issue 2

Did the transfer price meet the arm's length standard?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Is this a transaction between controlled parties? Remember that “control” is very broadly defined. 	Request and/or Review the following: <ul style="list-style-type: none"> ▪ Organizational Chart ▪ Transfer Pricing Studies ▪ Practice Unit, “Three Requirements of IRC 482”, DCN: ISI/9422.09_02(2013) ▪ Transfer Pricing Roadmap 	
<ul style="list-style-type: none"> ▪ Determine whether the prices charged are consistent with prices that would have been charged by uncontrolled entities under the same or similar circumstances. 	<ul style="list-style-type: none"> ▪ Contracts ▪ Intercompany Agreements ▪ Invoices ▪ Website Information ▪ Product Brochures 	

Issue 2, Step 3: Additional Factual Development (cont'd)

Overview of IRC Section 482

Issue 2

Did the transfer price meet the arm's length standard?

Fact Element	Resources	6103 Protected Resources
<p>In assessing whether the price paid is arm's length, consider all the facts and circumstances.</p> <ul style="list-style-type: none">▪ Did USP take into account the functions performed and risks assumed?▪ Did USP choose the best method based on the data available?▪ Did USP select appropriate comparables?	<ul style="list-style-type: none">▪ Treas. Reg. 1.482-1(b)▪ Treas. Reg. 1.482-1(d)	

Issue 2, Step 4: Develop Arguments

Overview of IRC Section 482

Issue 2

Did the transfer price meet the arm's length standard?

Fact Element	Resources	6103 Protected Resources
If it has been determined based on all the facts developed that the transfer price is not arm's length, a transfer pricing adjustment should be made to correct the pricing. An arm's length price should be determined using the best method and the difference in result would be proposed as a transfer pricing adjustment	<ul style="list-style-type: none">▪ Treas. Reg. 1.482-1(b)▪ Treas. Reg. 1.482-1(d)	



CONSULTATION: If you have an economist or engineer assigned to your case, make sure you incorporate their reports into the Facts, Law and Analysis sections of your Notice of Proposed Adjustment (NOPA).

Training and Additional Resources

Chapter 1.7.1 Overview of Transfer Pricing Concepts

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ 2012 (TPO) CENTRA – Overview and Introduction to Section 482 	
Issue Toolkits	<ul style="list-style-type: none"> ▪ IRM 4.61.3-4 - Functional Analysis Questionnaire ▪ Transfer Pricing Checklist ▪ IRM 4.61.3 Development of IRC section 482 Cases 	
Podcasts / Videos	<ul style="list-style-type: none"> ▪ 2011 (TPO) CPE CENTRA - Income Shifting Overview (Day 1) 	
Other Training Materials	<ul style="list-style-type: none"> ▪ Bittker and Lokken – Fed. Tax'n Inc. Est and Gift, Part 10, Chapter 79: Reallocation of Income and Deductions Among Related Taxpayers ▪ Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines 	

Glossary of Terms and Acronyms

Acronym	Definition
APMA	Advance Pricing and Mutual Agreement
CFC	Controlled Foreign Corporation
CPE	Continued Professional Education
CPM	Comparable Profits Method
CUP	Comparable Uncontrolled Price
DCN	Document Control Number
ETR	Effective Tax Rate
IPN	International Practice Network
IPS	International Practice Service
IRM	Internal Revenue Manual
LB&I	Large Business & International
NOPA	Notice of Proposed Adjustment
OECD	Organisation for Economic Co-operation and Development
TPO	Transfer Pricing Operations
UIL	Uniform Issue List
USP	United States Parent

Index of Related Issues

Issue	Associated UIL(s)	References
Controlled Transactions for IRC 482	9411	Practice Unit, “Controlled Transactions for IRC 482”, DCN: ISO/CU/C_1_02(2014)
Comparability Analysis for Tangible Goods Transactions - Outbound	9411	Practice Unit, “Comparability Analysis for Tangible Goods Transactions Outbound”, DCN: ISO/PUO/V_1_01(2014)
Risk Shifting to Controlled Foreign Corporations	9411.04	Practice Unit, “Risk Shifting to Controlled Foreign Corporations”, DCN: ISO/9411.04_01(2013)
Comparable Profits Method (CPM) Simple Distributor Outbound	9411.05	Practice Unit, “CPM Simple Distributor Outbound:”, DCN:ISO/9411.05_02(2014)
Revenue Procedure 99-32 Outbound Guidance	9411.07	Practice Unit, “Rev Proc 99-32 Outbound Guidance”, DCN: ISO/9411.07_03(2014)
Three Requirements of IRC 482	9422.09	Practice Unit, “Three Requirements of IRC 482”, DCN: ISI/9422.09_02(2013)
Taxpayer’s Affirmative Use of 482	9422.09	Practice Unit, “Taxpayer’s Affirmative Use of IRC 482”, DCN: ISI/9422.09_03(2013)
Best Method Determination for an Inbound Distributor	9422.09	Practice Unit, “Best Method Determination for an Inbound Distributor”, DCN: ISI/9422.09_04(2013)
Arm’s Length Standard	9422.09	Practice Unit, “Arm’s Length Standard”, DCN: ISI/9422.09_06(2013)