Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Process Unit – Overview

Shelf		Business Outbound		
Volume	1	Income Shifting Outbound	UIL Code	N/A
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Unit Name	Comparability Analysis for Tangible Goods Transactions – Outbound

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Income Shifting Outbound	N/A	N/A	N/A

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Introduction

Comparability Analysis for Tangible Goods Transactions – Outbound

Both U.S. and Foreign multinational enterprises (MNE) may seek to maximize after tax profits by shifting income from a high tax jurisdiction to a lower tax jurisdiction via controlled party transactions which are not conducted at arms length. Income shifting may be achieved through the sale of tangible goods, provision of services, loans, leases and/or license/transfer of intangibles between related parties at prices that are not arm's length. This Process Building Block will focus on analyzing the five comparability factors; functions, contracts, risks, economic conditions, and property and services. In addition, this unit looks at the identification and selection of third party transactions comparable to the controlled transactions under examination.

In general, the price of goods in a sales/lease transaction involving two uncontrolled parties is determined by market conditions and is assumed to be at arm's length. However, in a transaction between controlled parties, the price of goods may not always be determined by market conditions and may be manipulated in order to minimize tax. Both the U.S. IRC 482 rules and the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines (2010), provide that the price for transactions between controlled parties involving goods, services, intangible property (IP), rents, and loans should be the same as the price for transactions between uncontrolled parties under the same or similar circumstances. Thus, the degree of comparability between a controlled transaction and any uncontrolled comparables is central to the reliability of any transfer pricing analysis.

To determine the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, contractual terms used, risks borne, economic conditions encountered and the property and services employed by the parties in each transaction. This analysis is a prerequisite to identifying and selecting transactions comparable to the ones under examination. This analysis is not a transfer pricing method and does not itself determine an arm's length result. The purpose and goal of the analysis is to clearly identify and compare the economically significant activities undertaken by each party. A well performed analysis will establish the facts and circumstances needed to properly develop a transfer pricing case.

Introduction (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound

A comparability analysis, including the functional, risks, contractual and economic analyses, is a tool used to establish the facts and circumstances for IRC § 482 issues. While this analysis is a critical part of any transfer pricing audit, it may also be useful in analyzing a variety of tax issues other than transfer pricing, such as:

- Non-income Shifting Transfer of Intangibles
- Substantial Contribution to Contract Manufacturing (Subpart F exception)
- Domestic Production Deduction
- Worthless Stock deductions (under IRC 165(g)(3))
- Research and Experimental expenditure identification

This Building Block will not cover the analysis in these above mentioned areas. However, members of the domestic and international audit team and specialists should coordinate information gathering to avoid duplication of work for the exam team and/or making duplicative requests for information from the taxpayer.

Process Overview

Comparability Analysis for Tangible Goods Transactions – Outbound

Taxpayer's documents may not provide enough information to analyze all the functions, assets, risks, terms, economic conditions, property and services related to controlled transactions. Sometimes information provided by the taxpayer needs to be verified as part of the due diligence process. The examiner should know how to conduct a comparability analysis to determine the degree of comparability of transactions between related parties as compared to unrelated parties. Comparability analysis involves tracing the transaction at various stages from conceptualization to final sale.

The comparability factors listed in Treas. Reg. 1.482-1(d)(3) are:

- Functions
- Contractual Terms
- Risks
- Economic Conditions
- Property or Services

Comparability analysis requires examination of all factors that may impact comparability. It is important to note that the comparability factors are interrelated and that the list of factors in Treas. Reg. 1.482-1(d)(3) is not an exhaustive list. There may be other unlisted factors that could materially affect comparability. Thus, a comparability analysis may require consideration of factors not discussed in this Process Building Block. All the factors of comparability are related and must be looked at in tandem. For example, the fact that two parties perform identical manufacturing functions is virtually irrelevant if no consideration is given to the other factors, such as the contractual terms or economic conditions.

The examiner should identify and understand all the economically significant activities performed in connection with the controlled transaction. An economically significant activity is one that materially affects the price charged in a transaction and the profit earned from a transaction.

Process Overview (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound

After completing the comparability analysis and reviewing all the factors that might affect comparability, the examiner can determine if the comparables relied upon by the taxpayer are appropriate or whether they require adjustments or perhaps an alternative set of comparables is necessary.

The focus of this Building Block is how to conduct a comparability analysis relating to the transfer of tangible goods between controlled parties and will focus on the use of the Comparable Profits Method (CPM). This analysis is conducted on the entity that engages in routine activities and is the least complex of the controlled taxpayers (tested party). The tested party in a tangible goods transaction is typically the distributor. Distributors generally are the least complex entity in a controlled party enterprise and generally do not own valuable intangibles or unique assets that would distinguish it from potential uncontrolled comparables.

Although this Building Block focuses on comparability analysis for an outbound distributor, a similar analysis can be applied in a situation where a foreign MNE is the manufacturer and a U.S. entity/subsidiary is the distributor. See IPS Unit ISI/PUO/V6.7.1_01(2014): Comparability Analysis for Tangible Goods Transactions – Inbound.

This Building Block does not cover how to select the "best method." For selecting the best method see the IPS unit entitled Best Method Determination of an Inbound Distributor ISI/9422.09_04. While that unit is for an inbound transaction, the concepts are the same and can also be applied to an outbound transaction.

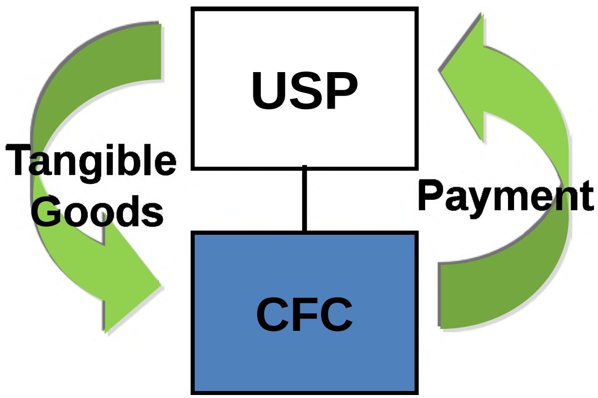
NOTE: The functional analysis is only one of the five factors of comparability listed in the regulations. In practice, often the term "functional analysis" is used to describe the complete "comparability analysis." Technically, the regulations describe the functional analysis as limited to the evaluation of the functions performed and resources employed by taxpayers in transactions. Comparability analysis includes all of the five factors listed in Treas. Reg. 1.482-1(d)(3), including the functional analysis.

Process Overview (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound

This Building Block focuses on the functions employed by a foreign subsidiary as a distributor for a US related parent and how to conduct a comparability analysis relating to the transfer of tangible goods between these controlled parties.

- US Parent (USP) owns 100% of Controlled Foreign Subsidiary (CFC).
- USP manufactures tangible goods and sells these to CFC which in turn sells the goods to the third party customers in Europe.
- USP and CFC have a transfer pricing study prepared by an outside consultant.
- The method to be evaluated in this process unit is the Comparable Profits Method (CPM) as applied to the distributor (CFC). (Although the same process applies to any tangible goods pricing methodology.)



Note: An assumption will be made that the tested party is the CFC distributor. Generally, an analysis would need to be performed before that assumption becomes fact.

Detailed Explanation of the Process

Comparability Analysis for Tangible Goods Transactions – Outbound

Analysis

Performing a comprehensive comparability analysis goes beyond interacting with the tax department and reading documents. A comprehensive comparability analysis primarily involves interaction with individuals throughout the taxpayer's organization. These interactions can take the form of questionnaires, interviews, site tours and third party contacts (interviews), if needed.

Questionnaires are one of the tools available in conducting a comparability analysis. Questionnaires are a useful means of gathering information from large numbers of taxpayer personnel or when gathering information from taxpayer personnel who are geographically remote. See Internal Revenue Manual (IRM) 4.61.3-4 Exhibit, *Transfer Pricing Functional Analysis Questionnaire* and the Transfer Pricing Roadmap.

However, there are some fundamental problems with questionnaires. For example, answers to questionnaires can be ambiguous or incomplete. This can lead to additional follow-up questions or the answers provided can be open to different interpretations. Another downside to utilizing questionnaires is that taxpayers (via the internal tax department or outside consultants) have more influence over the answers provided. Therefore, it is essential that the examiner carefully select and word the questions asked.

Interviews: In most cases an interview is a better means of understanding the comparability factors. A face to face interview can be more productive than a questionnaire. This format allows one question to lead into the next question. In an interview, the examiner can focus more detailed questions on issues that are identified during the interview. Live interaction allows the examiner to clarify any ambiguous answers or clear up any misunderstandings during the interview.

CONSULTATION: Consult with an Economist to determine if a questionnaire is the best means of performing the comparability analysis and to tailor the questionnaire for the specific taxpayer. Consult with Transfer Pricing Practice (TPP) Specialist and/or Counsel for assistance in preparing the questions to ask the taxpayer. Generally, an Economist, TPP Specialist and/or Counsel can assist in preparing for and conducting interviews.

Detailed Explanation of the Process (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound

A comprehensive comparability analysis generally includes physically touring the taxpayer's sites of operation. The observations made during a site visit will result in a thorough understanding of the comparability factors and will enable the examiner to identify additional issues. As a result, the examiner's report will have better descriptions of facts.

Prior to an interview or site visit the examiner should:

- Identify personnel to be interviewed and sites to be visited;
- Determine which Service personnel will attend and participate in asking questions;
- Agree and coordinate interviewees (with taxpayer);
- Prepare a list of topics to be covered and outline of questions in advance;
- See IRM 4.61.3-1 Exhibit, *On-Site Visitations.*

The Examiner should identify personnel to be interviewed and sites to be visited.

- Find out who the decision makers are for each of the comparability factors under analysis.
- Obtain organizational charts for each transacting party. The charts should identify entities, departments, personnel, and the functions they perform and risks they assume and to whom personnel report.
- Obtain personnel credentials including skill level and education possessed.
- Obtain personnel compensation levels including salaries, bonuses and stock based compensation.
- Obtain job descriptions.
- Request employee performance evaluations if relevant to the transfer pricing analysis.

Detailed Explanation of the Process (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound
Analysis
In some instances, it may be necessary for the examiner to interview personnel no longer employed by the taxpayer. The purpose of an interview and on-site visitation is to identify the functions performed, contractual terms, risks assumed, economic conditions and property or services provided. The Service personnel responsible for identifying and developing issues should attend interviews and site visits including: the examiner; the economist assigned to the case; and the manager responsible to the issue. If the taxpayer's operations are highly technical, an engineer should attend the site visits and interviews. Consider inviting Counsel to attend any interviews or site visits. The Service personnel attending interviews and site visits should choose a primary interviewer in advance. Usually an experienced team member is chosen as a primary interviewer. Service personnel not acting as the primary interviewer should plan on taking notes. Notes should be compared among team members. The Examiner should coordinate interview and site visits with the taxpayer. The examiner and the taxpayer should agree: ▪ Who will be interviewed, ▪ Which sites will be toured; ▪ A timetable for the interviews and site visits; and ▪ The length of time allowed for each interview; allowing enough time for note taking and follow-up questions. A site visit may involve a tour of various facilities. The examiner should get a description of what will be toured and know which taxpayer personnel they will be meeting with beforehand. It may be convenient to interview personnel the same day the facilities are being toured. Therefore, obtaining a list of personnel and their work location can prove helpful.

Detailed Explanation of the Process (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound
Analysis
Special planning needs to be taken when planning a **foreign site visit**. Examiner should obtain a written invitation from the taxpayer's foreign affiliate. The foreign government will need to know that the foreign affiliate has granted permission for the visit. Examiner should request permission to travel abroad well in advance. Foreign travel requests. Once you have collected all the information regarding the comparative analysis, get formal concurrence from the taxpayer that the information documented is factually correct. An efficient way of doing this is to issue an IDR with all the facts gathered and ask the taxpayer to provide any corrections and/or additional information. Attempt to resolve any open issues with the taxpayer. This document should be part of the case file and included in Form 886A.

Process Applicability

Comparability Analysis for Tangible Goods Transactions – Outbound

Taxpayer's documents may not provide enough information to adequately analyze the comparability factors in connection with uncontrolled transactions. Information provided by the taxpayer may need to be verified as part of the examination process.

Criteria	Resources
The examiner has identified significant controlled transactions.	Review Form 1120 - Schedule M-3, and Uncertain Tax Positions (UTP) Disclosures. Tie the financials to the tax return and note any differences. Review prior exam cycle files. Review Sch B of Form 5471 for the CFC.
The examiner has identified economically significant activities performed in connection with the controlled transaction.	Review the Transfer Pricing Study to understand the MNE structure, the activities performed, transaction materiality, and general risks of the transaction. Review the company websites for additional discussions about the taxpayer's activities.
The examiner has reviewed the general ledger and financial statements for expenses relating to the production of goods, such as manufacturing costs, depreciation of plants, R&D expense, warranty expenses etc.	Review USP's and CFC's Annual Reports/Financial Statements for confirmation that the information matches the transfer pricing study. Review the CFC's income statement and balance sheet for expenses that confirm its status solely as a distributor. Perform ratio analysis based on the financial information.

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Summary of Process Steps

Comparability Analysis for Tangible Goods Transactions – Outbound	
Process Steps	
The key factors that determine comparability (functions, contractual terms, risks, economic conditions, and property or services) should all be addressed as part of the comparative analysis. After performing the first five steps it will be possible to evaluate in Step 6 whether the controlled transaction is comparable to transactions between unrelated parties in order to establish whether the controlled transactions are priced at arm's length.	
Step 1	How to conduct a functional analysis
Step 2	How to conduct a contractual terms analysis.
Step 3	How to conduct a risk analysis.
Step 4	How to conduct an economics conditions analysis.

Summary of Process Steps (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Process Steps	
The key factors that determine comparability (functions, contractual terms, risks, economic conditions, and property or services) should all be addressed as part of the comparative analysis. After performing the first five steps it will be possible to evaluate in Step 6 whether the controlled transaction is comparable to transactions between unrelated parties in order to establish whether the controlled transactions are priced at arm's length.	
Step 5	How to conduct a property and services analysis.
Step 6	How to determine if transactions are comparable based on the factors analyzed in the comparability analysis.

Step 1: Functional Analysis

Comparability Analysis for Tangible Goods Transactions – Outbound

Step 1

Functional analysis involves tracing the flow of products at various stages from the conceptualization to final sale to understand what entities perform which functions

Considerations	Resources
Functional Analysis involves tracing the flow of products at various stages from the conceptualization to its final sales. The stages may include: ▪ Conceptualization ▪ R&D ▪ Various stages of production ▪ Testing and quality control ▪ Assembly, packaging and labeling ▪ Inventory management ▪ Transportation and warehousing ▪ Marketing and promotion ▪ Sales or internal use ▪ Warranty administration ▪ Various stages of financing the production and inventory	▪ Treas. Reg. 1.482-1(d)(3)(i), Functional analysis ▪ Transfer Pricing Roadmap [Plan the audit timeline and discuss the timeline with your manager and team coordinator.] ▪ IRM 4.61.3-4 Functional Analysis Questionnaire ▪ Checklist - IRC 482 Transfer Pricing Case Development Tool ▪ Transfer Pricing Study ▪ Intercompany Agreements

Step 1: Functional Analysis (cont’d)

Comparability Analysis for Tangible Goods Transactions – Outbound

Step 1

Functional analysis involves tracing the flow of products at various stages from the conceptualization to final sale to understand what entities perform which functions.

Considerations	References / Resources
In order to understand specific processes performed by USP and CFC, inquires need to be made into : ▪ Manufacturing; ▪ Selling and distribution; ▪ Assets, including intangible assets; and ▪ Resources employed Determine if you need to take the following actions to gather information to understand the specific processes- ▪ Do you need to issue IDRs or summons? ▪ Do you need to interview taxpayer employees? ▪ Do you need to contact IRS engineers? ▪ Do you need to contact third parties (outside experts, former employees)? ▪ Do you need to visit taxpayer’s sites related to transactions?	▪ Treas. Reg. §1.482-1(d)(3)(i)*, Functional Analysis* ▪ Transfer Pricing Study ▪ Transfer Pricing Roadmap ▪ IRM 4.61.3-4 Functional Analysis Questionnaire ▪ Checklist - IRC 482 Transfer Pricing Case Development Tool ▪ IRM 4.61.3.4.5 – How to Develop a Section 482 Case ▪ OJT for IEs-Development of Transfer Pricing Sec 482 Issues

Step 2: Contractual Terms

Comparability Analysis for Tangible Goods Transactions – Outbound

Step 2

A contractual terms analysis requires analyzing the tangible property sale to discover the terms and conditions of the sale.

Considerations	Resources
The contractual terms comparability factor is related to the comparability factor of risk. The significant contractual terms must be analyzed to determine comparability of the two transactions. The contractual terms found in the USP transaction will be used to find comparable internal or external transactions to evaluate the intercompany transfer price. Review written contracts. Review correspondence and/or communications between the parties. Sometimes, with related parties, modifications are made through email correspondence. Review the actual conduct of parties. Make sure it matches the written form. **CONSULTATION:** Consult with Counsel, an Economist, or Transfer Pricing Specialist to assist in determining if contract terms are comparable. Not every contractual term carries with it significant/material value. If the exam team plans to impute any contractual terms, consult with local Counsel and an Economist to determine the value of the contractual terms and whether adjustments to comparable data are required.	▪ Treas. Reg. §1.482-1(d)(3)(ii), Contractual terms ▪ Transfer Pricing Roadmap ▪ IRM 4.61.3 - Development of IRC 482 Issues IRM 4.61.3.5.4 *Contractual Terms* ▪ Intercompany Agreements

Step 2: Contractual Terms (cont’d)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 2	
A contractual terms analysis requires analyzing the tangible property sale to discover the terms and conditions of the sale.	
Considerations	**Resources**
Contractual Terms to review, include; Form of consideration charged or paid, Sales or purchase volume, Scope and terms of warranties provided, Rights to updates, revisions or modifications, Duration of relevant licenses, contracts or other agreements, and termination or renegotiation rights, Collateral transactions or ongoing business relationships between parties including ancillary or subsidiary services, and Extension of credit and payment terms. The economic substance of the transaction will be the most important consideration in any evaluation of comparability. Contractual terms may be inconsistent with the economic substance of the transaction or economic substance for a transaction without a written agreement may exist. The actual conduct of the parties and their respective legal rights will control. This will have to be deduced from the general ledger, written communications and interviews with personnel. The Government may impute a contractual agreement between the controlled taxpayers that is consistent with the economic substance of the transaction.	

Step 2: Contractual Terms (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 2	
A contractual terms analysis requires analyzing the tangible property sale to discover the terms and conditions of the sale.	
Considerations	**Resources**
Form of consideration charged or paid: Determine if the form of consideration paid was cash, accounts receivable, a debt instrument, or other form of consideration. Verify the above terms by reviewing the general ledger for an accounts receivable account related to the inventory purchase. Verify that the contract, invoice and general ledger accounts are all coordinating such that the substance follows the form. **Sale or purchase volume:** The examiner will need to identify the quantity of product purchased by CFC from USP. Generally, market dynamics indicate that a higher purchase volume will result in a lower purchase price because of volume discounts. However, this could be dependent on the industry in which the taxpayer participates. Not all markets are the same. A minimum or required purchase volume could reduce CFC's profit if the sub cannot sell all the inventory and the inventory can not be returned.	▪ Transfer Pricing Roadmap ▪ Transfer Pricing Study ▪ Intercompany Agreements ▪ Invoices ▪ Books and Records (G/L, Receivables and Payables Ledger, etc.) ▪ Treas. Reg. §1.482-1(d)(3)(ii)(C), *Contractual term - Example 1*

Step 2: Contractual Terms (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 2	
A contractual terms analysis requires analyzing the tangible property sale to discover the terms and conditions of the sale.	
Considerations	**Resources**
Scope and terms of warranties provided: Identify the warranties provided and which party is responsible for processing, repairing and paying any claims. Generally, a distributor will not be liable for warranties. Most often, the manufacturer is responsible for the warranty and replacement of defective goods. **Rights to updates, revisions or modifications:** Today, products are constantly going through design improvements. The contract generally determines if a taxpayer is eligible for these improvements automatically, or if they would need to be separately negotiated. The contract(s) should be read to see if there is any language addressing design improvements. If not, determine how design improvements are dealt with or controlled. Determine if the taxpayer is eligible to automatically receive inventory subject to updated design specifications or if a new contract is required to be negotiated.	▪ Treas. Reg. §1.482-1(d)(3)(ii) ▪ Transfer Pricing Roadmap ▪ Transfer Pricing Study ▪ Intercompany Agreements ▪ Invoices ▪ Books and Records (G/L, Receivables and Payables Ledger, etc.)

Step 2: Contractual Terms (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 2	
A contractual terms analysis requires analyzing the tangible property sale to discover the terms and conditions of the sale.	
Considerations	**Resources**
Duration of relevant licenses, contracts or other agreements, and termination or renegotiation rights: Contracts can be short-term (one year or less) or long-term (greater than one year). A longer term contract provides more stability. Rights to terminate or renegotiate can mitigate transactions or potential trouble areas not foreseen (e.g. labor, economy or weather). Determine how termination rights are handled. Determine if modification rights exist and how they are handled.	▪ Treas. Reg. §1.482-1(d)(3)(ii) ▪ Intercompany Agreements
Collateral transactions or ongoing business relationships between parties including ancillary or subsidiary services : Identify if other transactions, business relationships or services exist between the buy and seller. A better price may be negotiated depending on the relationship between the buyer and seller and how many different transactions for products and/or services are involved. (For example; it is cheaper to purchase bundle services from your cable provider to get telephone, cable and internet service combined as opposed to pricing each service out separately.)	▪ Transfer Pricing Roadmap ▪ Transfer Pricing Study

Step 2: Contractual Terms (cont’d)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 2	
A contractual terms analysis requires analyzing the tangible property sale to discover the terms and conditions of the sale.	
Considerations	**Resources**
Extension of credit and payment terms : Determine the payment terms for the purchase of the inventory; Cash on delivery, 30 days payment, etc., or convertible into a long term loan. The actual substance of the transaction should also be observed (i.e.; has the accounts receivable balance been unpaid for the past two years?). This can be performed by tracing transactions through from the purchase order/invoice to final payment. Terms of a contract can be deduced from correspondence, communications (written and oral), purchase orders, invoices, past due payment/collection letters and other related documents.	▪ IPS Unit: Intercompany Interest Rates under the Situs Rule of IRC Section 482 ISI/9422.08_01(2013) ▪ Treas. Reg. §1.482-2(a)(2) discusses arm’s length interest rates for credit and loans ▪ Invoices ▪ Books and Records

Step 3: Risk Analysis

Comparability Analysis for Tangible Goods Transactions – Outbound

Step 3

Risk analysis requires identification of which related party bears each type of significant risk.

Considerations	Resources
Analysis of functions performed and risks assumed by related parties provides the factual foundation for analyzing the arm's length nature of intercompany transactions. The functions performed by each party to the transaction typically correlate with the risks assumed and intangibles contributed. Risk may be allocated among the parties according to the contract between the parties. However, the actual conduct of the parties must follow the contractual terms for the economic substance of the transaction to be respected. Risk allocations lack economic substance if they are made after outcome of the risk is known (or should reasonably have been known). Relevant facts in determining economic substance are: ▪ Whether the related parties' conduct over time is consistent with the contractual terms; or where conduct has changed without change of the contractual terms. ▪ Whether CFC has the capacity to fund losses that might be expected to result from assumption of the risk or whether another party might ultimately be responsible for the losses. ▪ The relative extent of CFC's managerial or operational control over business activities and decisions that directly influence the amount of income or loss recognized versus what the parent controls.	▪ Treas. Reg. §1.482-1(d)(3)(iii), Risk ▪ IRM 4.61.3 - Development of IRC 482 Issues IRM 4.61.3.5.3, *Risk Analysis*

Step 3: Risk Analysis (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 3	
Considerations	**Resources**
The results found from the risk analysis of the US Sub transaction will be used to find comparable internal or external transactions to evaluate the intercompany transfer price. There are several significant risks that could affect the comparability of the transaction(s). The particular facts and circumstances of each case must be addressed. **CONSULTATION:** Consult with Counsel, Economist, Financial Products Specialist and/or Transfer Pricing Specialist as necessary. The Specialists can assist in assessing many areas of risk with the related party transaction(s).	▪ Treas. Reg. §1.482-1(d)(3)(iii), Risk ▪ IRM 4.61.3 - Development of IRC 482 Issues IRM 4.61.3.5.3, *Risk Analysis*

Step 3: Risk Analysis (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 3	
Risk analysis requires identification of which related party bears each type of significant risk.	
Considerations	**Resources**
The following, not all inclusive, is a list of potential risks to examine. In each case, an interview of the taxpayer should be performed to develop the particular facts and circumstances. ▪ Market risk ▪ Inventory risk ▪ Product liability risk ▪ Warranty risk ▪ Credit risk ▪ Foreign exchange risk ▪ Advertising and marketing risk ▪ Research and development risk ▪ Intangibles risk ▪ General business risks related to the ownership of property, plant and equipment.	▪ IRM 4.61.3 - Development of IRC 482 Issues IRM 4.61.3.5.3, *Risk Analysis* ▪ Transfer Pricing Roadmap ▪ Transfer Pricing Functional Analysis Questionnaire

Step 3: Risk Analysis (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 3	
Risk analysis requires identification of which related party bears each type of significant risk.	
Considerations	**Resources**
Market risk : The risk that the distributor may be unable to resell the products at a price that will allow it to generate a profit or may be unable to resell the products (at all). This risk may result from business cycles, increased competition, declines in market demand, or changes in market perceptions. Normally, distributors bear market risk. Identify which party bears market risk.	▪ Transfer pricing study ▪ Intercompany agreements ▪ Purchase contracts and invoices
Inventory risk : The risk to the change in value of raw materials, work in process and finished goods due to changes in market prices, damage, defects, or obsolescence. A distributor would normally hold inventory of finished product. Determine which party bears inventory risk.	▪ Internal manuals on inventory processing ▪ Trial balance ▪ Audited financial statements

Step 3: Risk Analysis (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 3	
Risk analysis requires identification of which related party bears each type of significant risk.	
Considerations	**Resources**
Product liability risk: The risk a company can be held liable for damages caused by defective product design, manufacturing, transit, or warehousing. Distributors generally do not have product liability risk since they are not responsible for the product design or manufacturing. A distributor's product liability is normally limited to defects caused by damage to product in warehouse or in transit to the customer. Determine which party bears product liability risk. **Warranty risk:** The financial responsibility for the cost to replace or repair defective products or for reimbursing the purchase price to customers upon return of a defective product are warranty risks. A distributor normally would not be responsible for warranty claims due to product design or manufacturing, but may be responsible if the defect is due to damage in the warehouse or in transit to the customer. Identify which party bears warranty risk.	▪ Transfer pricing study ▪ Intercompany agreements ▪ Internal manuals for product liability ▪ Accounting records and audited financials ▪ Internal manuals on warranty processing and warranty materials packaged with product

Step 3: Risk Analysis (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 3	
Risk analysis requires identification of which related party bears each type of significant risk.	
Considerations	**Resources**
Credit risk: This risk is associated with the possibility of late payment or non-payment by the customer. Distributors generally have credit risk and have control over related management functions such as; the review and approval process before granting credit to customers and monitoring and collection of receivables. It is important to gain an understanding of the credit approval process and collection procedures. Determine which party assumes credit risk. **Foreign exchange risk:** The risk exists when profits can be affected by fluctuations in the exchange rate of a currency other than the functional currency in which the entity operates. A distributor operating in the US would generally purchase products from a related manufacturer in US dollars and sell to customers in US dollars. Identify which party assumes foreign exchange risk.	▪ Transfer pricing study ▪ Intercompany agreement ▪ Intercompany invoices ▪ Internal company manuals ▪ Financial statements

Step 3: Risk Analysis (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 3	
Risk analysis requires identification of which related party bears each type of significant risk.	
Considerations	**Resources**
Advertising and marketing risk: The risk associated with spending to promote the brand and other marketing intangibles to achieve intended results. Distributors should generally not be the economic owner of valuable brand intangibles and would not bear the related costs. Distributors may have marketing intangibles, such as corporate name, customer list, customer relationships, etc. Determine which party incurs advertising and marketing risk. **Research and development (R&D) risk:** The risk of unsuccessful R&D spending. Risk may include failure to produce new product, product improvement or design, intangible asset, etc. which assist the company in increasing profits. Distributors do not generally incur any R&D costs. Identify which party incurs research and development risk.	▪ Transfer pricing study ▪ Intercompany agreements ▪ Financials ▪ Trademark and trade name registrations

Step 3: Risk Analysis (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 3	
Risk analysis requires identification of which related party bears each type of significant risk.	
Considerations	**Resources**
Intangibles ownership risk: The risk of obsolescence of existing intangibles and the risk of infringing on the intellectual property (IP) rights of unrelated enterprises. Distributors generally are not the economic owners of any valuable intangibles. Determine which related party assumes intangibles ownership risk. **General business risks:** The risks related to the ownership of property, plant and equipment (PP&E). The risk of ensuring the PP&E is protected against physical loss, wear and tear, obsolescence, or damage. Determine which party bears the general business risks.	▪ Royalty agreements ▪ Intercompany licensing agreements ▪ U.S. Patent & Trademark Office ▪ Financial Statements ▪ Books and records ▪ Property records search (Accurint) ▪ Insurance policies

Step 4: Economic Conditions

Comparability Analysis for Tangible Goods Transactions – Outbound

Step 4

An economic conditions analysis requires a comparison of the significant economic conditions that could affect the prices that would be charged, or the profit that would be earned, in each of the transactions.

Considerations	Resources
In order to determine the degree of comparability of the controlled transaction with an uncontrolled comparable transaction it is necessary to compare the economic conditions that could affect the price of the transaction or the profit resulting from the transaction. The following economic conditions can affect prices or profits: ▪ Similarity of geographic markets; ▪ Relative size of each market and its level of economic development; ▪ Level of the market; ▪ Applicable market shares for the relevant products, properties or services; ▪ The location specific costs of production and distribution; ▪ Extent of competition in each market for the relevant products or services; ▪ Economic condition of the particular industry; and ▪ Alternatives realistically available to the buyer and seller.	▪ Treas. Reg. §1.482-1(d)(3)(iv), *Economic conditions* ▪ IRM 4.61.3 - Development of IRC 482 Issues *IRM 4.61.3.5.5, Economic Conditions*
CONSULTATION: Consult with Counsel, an Economist, or a Transfer Pricing Specialist to assist in determining if economic conditions are comparable to the transaction being analyzed.	

Step 4: Economic Conditions (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 4	
An economic conditions analysis requires a comparison of the significant economic conditions that could affect the prices that would be charged, or the profit that would be earned, in each of the transactions.	
Considerations	**Resources**
Similarity of geographic markets: The examiner must identify the relevant geographic market in which the taxpayer operates. Uncontrolled comparable companies ordinarily should be derived from the same geographic market in which the controlled taxpayer operates. There can be significant differences in economic conditions in different markets that can affect price. **Relative size of each market and its level of economic development:** The examiner should obtain information regarding the size and maturity of the market in which the taxpayer operates. For example, if it was determined that US Sub's market had estimated annual value in excess of five billion dollars the comparable company search may eliminate companies which are in a start-up stage or lack 3 years of financial data. **Level of the market:** The examiner should obtain information regarding the level of the market in which the taxpayer operates. A comparable company search for such a distributor would eliminate companies that operate at a different level of the market.	▪ Transfer Pricing Study ▪ Taxpayer's Internet site / Internet Research ▪ Treas. Reg. §1.482-1(d)(4)(ii)(A), *Different geographic markets*

Step 4: Economic Conditions (cont’d)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 4	
An economic conditions analysis requires a comparison of the significant economic conditions that could affect the prices that would be charged, or the profit that would be earned, in each of the transactions.	
Considerations	**Resources**
Applicable market shares for the relevant products, properties or services: The examiner should obtain information regarding the taxpayer’s market share. For example, if US Sub has less than 10% market share then the team will look for major competitors with similar market share. **The location specific costs of production and distribution**: The examiner will need to determine where the tested operations/transactions are performed. Certain locations may offer location savings relative to other locations. Locations savings refers to the relative competitive positions of buyers and sellers in each market. The location specific costs will become a more material fact when the manufacturer operates outside the US in a low wage country and the taxpayer uses comparable transactions where the manufacturers operate in high cost countries. **Extent of competition in each market for the relevant products or services:** The examiner should determine whether the distributor operates in a competitive market where prices are determined by normal market forces and neither the seller nor the buyer has sufficient market power to affect price. (For example; A monopolistic market will have different considerations than a highly competitive market.)	▪ Treas. Reg. §1.482-1(d)(4)(i), *Market share strategies* ▪ Financial statements ▪ Transfer pricing study ▪ Market reports ▪ Government industry reports ▪ Taxpayer website. ▪ Treas. Reg. §1.482-1(d)(4)(ii)(C), *Location savings*

Step 5: Property and Services

Comparability Analysis for Tangible Goods Transactions – Outbound

Step 5

A property and services analysis requires analyzing the tangible property sale to discover if any other property or any services are embedded in the transaction.

Considerations	Resources
A property and services analysis requires analyzing the tangible property sale to discover if other property or services are embedded in the transaction. Any additional property or services embedded in the transaction will also need to be considered for the comparables selected. There may be circumstances where the embedded property or service must be separately evaluated, and there may be other situations where the property or services may need to be aggregated. The tangible property sale invoice and/or contract may not discuss embedded property or services. Therefore, the examiner may need to take additional steps to ensure the distributor has no additional embedded property or services in the transaction that would need to be valued. An example of embedded property could be a valuable intangible asset which accompanies the tangible inventory product or inventory may come with free service repair for one year. These items could be valuable embedded property or services. The facts and circumstances of each case will dictate whether there is audit risk in this area. This analysis will occur concurrently with the other comparability factors analysis.	▪ Treas. Reg. §1.482-1(d)(3)(v), *Property or services* ▪ Treas. Reg. §1.482-3(f), *Coordination with intangible property rules* and -9(m)(1), *Coordination with transfer pricing rules for other considerations for separate evaluation of embedded transactions* ▪ IRM 4.61.3 - Development of IRC 482 Issues IRM 4.61.3.5.6, *Property and Services* ▪ Form 5471 Information Return of U.S. Persons With Respect to Certain Foreign Corporations (Schedule M)

Step 6: Comparability

Comparability Analysis for Tangible Goods Transactions – Outbound

Step 6

Finding an exact comparable will be highly unlikely. An examiner will need to evaluate comparables that are not exact but are very similar to CFC.

Considerations	Resources
To determine the correct arm's length price for the sale of the inventory you must find comparable transactions to compare the taxpayer related-party transactions. Comparable transactions do not need to be identical to the taxpayer's controlled transaction. The comparable *does need* to be sufficiently similar so that it provides a reliable measure of an arm's length result. For all transfer pricing methods, the degree of comparability between the tested party (controlled taxpayer) and the uncontrolled taxpayer (comparables) depends on all the relevant facts and circumstances. One pricing method, the Comparable Profits Method compares the profitability of the tested party, measured by a profit level indicator (PLI), to the profitability of uncontrolled taxpayers in *similar* circumstances. PLIs are generally based on operating profit. Operating profit is usually less sensitive than gross profit to product differences. Therefore, reliability under the CPM is less dependent on product similarity than other methods. This means that when using the CPM, the products will not need to be exactly the same.	▪ Treas. Reg. §1.482-1(d)(2), *Standard of comparability* ▪ *Transfer Pricing Study* ▪ IPS Unit: CPM Simple Distributor Inbound ISI/9422.07_07(2013) discusses how to use the CPM method as applied to a distributor ▪ IPS Unit: Comparability Analysis for Tangible Goods Transactions Inbound ISI/9422.07_01 thru _06(2013) for an inbound distributor discusses selection of the tested party

Step 6: Comparability (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound	
Step 6	
Finding an exact comparable will be highly unlikely. An examiner will need to evaluate comparables that are not exact but are very similar to CFC.	
Considerations	**Resources**
To following steps can be used to evaluate comparables: ▪ Review the comparables from the taxpayer's transfer pricing study. The comparables may be attached as an exhibit to the transfer pricing study or the examiner may need to request them. ▪ Also request the rejected comparables and the evaluation process and steps used to narrow the comparables. ▪ The examiner must evaluate these comparables and decide if the Government agrees with the list of comparables. The examiner should search for additional comparables using Capital IQ. ▪ Economists have access to Compustat and if assigned to the case will also evaluate the comparables and search for additional comparables. ▪ Findings should be shared with the taxpayer. Any differences should be discussed with the taxpayer.	▪ Transfer pricing study ▪ Capital IQ ▪ Compustat

Step 6: Comparability (cont’d)

<table>
<tr><th colspan="2">Comparability Analysis for Tangible Goods Transactions – Outbound</th></tr>
<tr><td colspan="2">Step 6</td></tr>
<tr><td colspan="2">Finding an exact comparable will be highly unlikely. An agent will need to evaluate comparables that are not exact but are very similar to the CFC.</td></tr>
<tr><th>Considerations</th><th>Resources</th></tr>
<tr><td>Oftentimes, the taxpayer may make adjustments to comparable data for material differences. Differences which are material should be adjusted. A material difference is a difference that would affect the measure of the arm’s length result under the CPM.

Generally, the adjustment will be made to the comparable uncontrolled selection. The adjustments that are made must be based on commercial practices, economic principles, or statistical analysis. The extent and reliability of the adjustments made to the comparables will affect the reliability of the result.

The most common adjustments account for differences in book accounting practices between the controlled and uncontrolled transactions. These adjustments include adjustments for differences in; accounts receivable, accounts payable, inventory, assets, and stock based compensation.

CONSULTATION: Generally, an Economist will assist in the calculation of any material difference adjustments.</td><td>▪ Transfer pricing study
▪ Compustat</td></tr>
</table>

Definitions

Comparability Analysis for Tangible Goods Transactions – Outbound
Description
▪ Arm's Length Standard - A controlled transactions meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled/unrelated parties had engaged in the same transaction under the same circumstances (arm's length result). ▪ Controlled Parties - Two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests. Controlled entities are often referred to as "related" parties.

Examples of the Process

Comparability Analysis for Tangible Goods Transactions – Outbound
Description
The following examples illustrate how comparability impacts the selection of comparables. **BAA Co** is labeled as a wholesale parts distributor in CFC's comparables. However, further investigation shows it is a parts manufacturer and a distributor. BAA does not segment its financial data and it is impossible to reliably extract the distributor profit from the manufacturer profit. This demonstrates the importance of looking to the actual activity of a potential comparable. The example demonstrates the importance of performing research into the actual activity of the comparable. If the financials had been segmented, it *may* have been possible to use BAA Co as a comparable, but without segmented data (as in this example) there is no reliable way to use BAA Co's financial data for assessing results from its distribution activities. **MAA Co** is labeled as a wholesale parts distributor in CFC's comparables. The company is a public company and vast data is available online. It is determined that while MAA Co is a parts distributor, it also repairs the parts it distributes and does all the warranty service on the parts. However, reliable segmented data was available. The Economist reviewed the data and felt that reliable adjustments could be made and were made properly in the transfer pricing study. The example demonstrates that segmented data can be used and reliable adjustments can be made to meet the standards of comparability. The International Examiner and Economist should work together to perform the comparability analysis.

Examples of the Process (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound

Description

The following examples illustrate how comparability factors impact the selection of comparables

PAA Co is labeled as a wholesale parts distributor in CFC's comparables. The entity reports a loss. Further examination shows that the business is in the start up phase. The Government rejects the comparable due to the stage of business cycle. The loss reported was not the imperative fact; the imperative fact was the stage of the business cycle.

The example demonstrates that loss companies can be used as comparables and should not be rejected due to a reported loss. The example also demonstrates the importance of looking beyond the loss for the reason of the loss. A start up company is not generally comparable to an established company.

DAA Co is labeled as a wholesale parts distributor in CFC's comparables. Upon reviewing the comparable data used by the taxpayer, the examiner notices that for the three year's subject of the calculation, two year's have N/A listed as the profit. A Capital IQ and Compustat search for this company also show only one of the three year's worth of data reported. The Government rejects the comparable due to lack of data.

The example demonstrates that multiple year's worth of data must be used to calculate an accurate arm's length price. If three year's worth of data is being used to calculated the arm's length price and two of those year's worth of data are missing for the comparable company, then the comparable may likely need to be removed from the comparable set. Using only one year's worth of data may unduly influence the results, especially in a period of rising or falling economy.

Training and Additional Resources

Comparability Analysis for Tangible Goods Transactions – Outbound		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
CENTRA sessions	▪ 2012 (IBC) CPE CENTRA - Performing Functional Analysis by Engineering International Issues Team (HHR344383). ▪ 2011 (TPO) CPE CENTRA - Economic Analysis (Day 3) ▪ 2011 (TPO) CPE CENTRA - Risk and Comparability (Day 3) ▪ 2013 (TPO) CPE CENTRA - PLIs in a CPM World (FPM304428) ▪ 2012 (TPO) CPE CENTRA - Comparable Profits Method (LHL430034)	▪ Text
Issue Toolkits	▪ Overview of IRC 482 ▪ Transfer Pricing Roadmap ▪ Transfer Pricing Functional Analysis Questionnaire ▪ IRM 4.61.3.4.5 – How to Develop a Section 482 Case ▪ Checklist – IRC § 482 (Transfer Pricing)	▪ Text

Training and Additional Resources (cont'd)

Comparability Analysis for Tangible Goods Transactions – Outbound		
Type of Resource	**Descriptions and/or Instructions for Accessing**	**References**
OECD Transfer Pricing Guidelines	▪ Article 9	OECD Transfer Pricing Guidelines
Databases / Research Tools	▪ BNA Tax Management Int'l Portfolio 886-2nd s II - Transfer Pricing - The Regulations ▪ BNA Tax Management Int'l Portfolio 890 - Transfer Pricing	BNA 886-2nd TMFEDPORT No 886 s II BNA Portfolio #890, WS 1

Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled foreign subsidiary of USP
COGS	Cost of Goods Sold
CPM	Comparable Profits Method
IDR	Information Document Request
IP	Intangible Property
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
ISI	Income Shifting Inbound
ISO	Income Shifting Outbound
MNE	Multinational Enterprise
OECD	Organization for Economic Co-operation and Development
SBC	Stock Based Compensation
TP	Transfer Pricing

Glossary of Terms and Acronyms (cont'd)

Acronym	Definition
TP	Transfer Pricing
UIL	Uniform Issue List
USP	United States Parent
UTP	Uncertain Tax Position
WIP	Work in Process

Index of Related Issues

Issue	Associated UIL(s)	References
Embedded Services and Embedded Intangibles	9411.02	IPS Unit to be developed
Provision of High Value Services	9422.05	IPS Unit to be developed
Sale of Tangible Goods	9411.05	IPS Unit: ISO/9411.05_01(2013) Sale of Tangible Goods from a CFC to a USP CUP Method
Overview of IRC Section 482	9411.07	IPS Unit: ISO/9411.07_01(2013) Overview of IRC Section 482
Comparable Profits Method	9422.07	IPS Unit: ISI/9422.07_07(2013) CPM Simple Distributor Inbound
Resale Price Method	9422.07	IPS Unit: ISI/9422.07_08(2013) Inbound Resale Price Method Routine Distributor
Purchases of Tangible Goods	9422.07	IPS Unit: ISI/9422.07_05(2013) Purchase of Tangible Goods from a FP - CUP Method
Best Method	9422.09	IPS Unit: ISI/9422.09_04(2013) Best Method Determination for an Inbound Distributor
Arm's Length Standard	9422.09	IPS Unit: ISI/9422.09_06(2013) Arms Length Standard