

Office of Chief Counsel
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Memorandum

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to: Jeffrey Johnson, International Technical Advisor
(Prefiling and Technical Guidance, LMSB)

from: John M. Breen, Branch Chief
(CC:INTL:B6)

subject: Treatment of Certain Adjustments in Determining Net Section 482 Transfer Price
Adjustment

This Chief Counsel Advice responds to your request for assistance. This advice may
not be used or cited as precedent.

LEGEND

USCorp =

US Partnership =

ForCorp =

Foreign Subs =

Years at Issue =

Products =

ISSUES

Whether, under the facts below, the net section 482 transfer price adjustment proposed by Exam should be reduced under the section 6662(e)(3)(B)(i) exclusion or the section 6662(e)(3)(B)(iii) exclusion for purposes of applying the threshold requirements of section 6662(e)(1)(B)(ii).

CONCLUSIONS

Whether the section 6662(e)(3)(B)(i) exclusion applies is a question of facts and circumstances that cannot be addressed appropriately in this memorandum. We conclude that the section 6662(e)(3)(B)(iii) exclusion does not apply to the net section 482 transfer price adjustment proposed by Exam, because no portion of that adjustment is attributable to transactions solely between foreign corporations. Rather, the entire adjustment is attributable to controlled transactions between a domestic member and a foreign member of the controlled group.

FACTS

USCorp is a corporation organized in the United States. USCorp and its domestic subsidiaries (collectively "Taxpayer") filed a consolidated Federal income tax return for the Years at Issue. Taxpayer, through direct and indirect interests, owns 100% of US Partnership, a domestic partnership. Taxpayer also owns 100% of ForCorp, a foreign corporation. ForCorp, in turn, owns majority interests in several lower-tier foreign manufacturing corporations ("Foreign Subs"). ForCorp and Foreign Subs (collectively "Foreign Group") are involved in various stages of manufacturing certain Products. Taxpayer and Exam disagree as to the nature and extent of the manufacturing functions performed by ForCorp. Taxpayer views ForCorp as a manufacturer similar to Foreign Subs. In contrast, Exam views ForCorp as a management company, rather than a manufacturer, because ForCorp does not own or operate any manufacturing facilities. Taxpayer and Exam nevertheless agree that after the final stage of the manufacturing process is complete, ForCorp purchases finished Products from Foreign Subs.¹ US Partnership, in turn, purchases the finished Products from ForCorp. US Partnership distributes these purchased finished Products through its global network of distributors.

Pursuant to the best method rule of Treas. Reg. § 1.482-1(c), Taxpayer applied the comparable profits method ("CPM") as the best method to determine the arm's length price for the finished Products purchased by US Partnership from ForCorp. In applying the CPM, Taxpayer selected ForCorp as the tested party within the meaning of Treas. Reg. § 1.482-5(b)(2).

¹ The purchases of finished Products by ForCorp from Foreign Subs are the foreign-to-foreign transactions that Taxpayer believes are relevant to the section 6662(e)(3)(B)(iii) issue, as discussed below.

Exam determined that Taxpayer's CPM analysis was flawed because Taxpayer failed to perform a full functional analysis of the manufacturing processes performed by ForCorp and Foreign Subs. Rather, Taxpayer focused only on a functional analysis of ForCorp.² Exam concluded that it could not determine the arm's length price for the Products without taking into account the functions performed by both ForCorp and Foreign Subs. Exam concluded that Taxpayer's application of the selected transfer pricing methodology allowed shifting of income from US Partnership to the Foreign Group, in part because the prices paid by ForCorp to Foreign Subs (and reflected in ForCorp's cost of goods sold) were not in accordance with the arm's length standard.

Based on the above analysis, Exam decided to apply the CPM, using the Foreign Group as the tested party. Under that approach, Exam determined that the prices paid by US Partnership to ForCorp for the finished Products were too high and adjusted the consideration accordingly. The adjustment resulted in allocation of additional taxable income to Taxpayer through its ownership interest in US Partnership.

LAW AND ANALYSIS

A. Section 6662(e) – In General

Under section 6662(a) and (b)(3), a taxpayer is potentially subject to penalties for underpayments of tax that are attributable to a "substantial valuation misstatement." A substantial valuation misstatement may exist if "the net section 482 transfer price adjustment for the taxable year exceeds the lesser of \$5,000,000 or 10 percent of the taxpayer's gross receipts." I.R.C. § 6662(e)(1)(B)(ii).³

A net section 482 transfer price adjustment is the net increase in taxable income in a taxable year as a result of section 482 adjustments in the price for any property, services, or for the use of property. I.R.C. § 6662(e)(3)(A).

In determining a net section 482 transfer price adjustment for purposes of applying the threshold requirements of section 6662(e)(1)(B)(ii), certain portions of the net increase in taxable income may be excluded from the calculation if the taxpayer satisfies certain requirements with respect to specified transfer pricing methods and documentation.

² Exam also concluded that Taxpayer's functional analysis was flawed because Taxpayer inappropriately attributed manufacturing functions to ForCorp that it did not in fact perform. In addition, Exam concluded that Taxpayer's comparability analysis was flawed because Taxpayer chose inappropriate comparables.

³ Alternatively, a taxpayer is potentially subject to penalties for underpayments of tax that are attributable to a "gross valuation misstatement." A gross valuation misstatement in the net section 482 transfer price adjustment context is a substantial valuation misstatement under section 6662(e)(1)(B)(ii) but determined by substituting the values \$20 million and 20% for the values \$5 million and 10%, respectively. I.R.C. § 6662(h)(2)(A)(iii). In the case of a gross valuation misstatement under section 6662(h), the 20% penalty under section 6662(a) is increased to 40%. I.R.C. § 6662(h)(1). Whether the valuation misstatement in this case is substantial or gross is not analyzed here. However, the substantial valuation misstatement analysis discussed herein applies equally to gross valuation misstatements.

I.R.C. § 6662(e)(3)(B)(i) (“specified method with documentation exclusion”). Taxpayers may also exclude certain portions of the net increase in taxable income that are attributable to transactions solely between foreign corporations. I.R.C. § 6662(e)(3)(B)(iii) (“foreign-to-foreign transaction exclusion”).⁴ The specified method with documentation exclusion of section 6662(e)(3)(B)(i) and the foreign-to-foreign transaction exclusion of section 6662(e)(3)(B)(iii) are further described in Treas. Reg. § 1.6662-6(d)(2) and (4), respectively.

B. Specified Method with Documentation Exclusion

The specified method with documentation exclusion applies if:

(I) it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the regulations prescribed under section 482 and that the taxpayer’s use of such method was reasonable,

(II) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with such a method and which establishes that the use of such method was reasonable, and

(III) the taxpayer provides such documentation to the Secretary within 30 days of a request for such documentation.

I.R.C. § 6662(e)(3)(B)(i); see also Treas. Reg. § 1.6662-6(d)(2).

In the instant case, whether Taxpayer reasonably concluded that its selection and application of the CPM provided the most reliable measure of an arm’s length result and whether Taxpayer maintained and provided documentation would require an evaluation of the facts and circumstances that is beyond the scope of this memorandum. In performing such an analysis, it may be necessary to perform a complete functional analysis, which would generally include a consideration of controlled transactions with other controlled parties. For example, evaluation of the roles of foreign related parties may be critical to understanding the functions performed, risks assumed, and resources employed by the tested party in light of the total value chain. Moreover, understanding the functions performed by all members within a supply chain may be critical to determining the best method under Treas. Reg. § 1.482-1(c) and to evaluating relative comparability between uncontrolled transactions and the controlled transactions under examination. Taxpayer concedes that Exam “has the power under Section 482 to

⁴ Because the instant case involves the application of the CPM, which is a specific pricing method within the meaning of section 6662(e)(3)(B)(i), the exclusion under section 6662(e)(3)(B)(ii) and Treas. Reg. § 1.6662-6(d)(3), which applies to methods other than specific pricing methods, does not apply here.

review transactions at all levels that could be connected to the controlled transaction with a US person.”⁵

C. Foreign-to-Foreign Transaction Exclusion

The central issue in this case is whether any portion of the net section 482 transfer price adjustment proposed by Exam is attributable to transactions solely between foreign corporations. Section 6662(e)(3)(B)(iii) provides that, for purposes of determining whether the threshold requirements (i.e., a net section 482 transfer price adjustment greater than \$5,000,000 or 10% of the taxpayer’s gross receipts) are met, the net section 482 transfer price adjustment is reduced by any portion of the net increase in taxable income:

attributable to any transaction solely between foreign corporations unless, in the case of any such corporations, the treatment of such transaction affects the determination of income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

See also Treas. Reg. § 1.6662-6(d)(4) (providing exclusion for certain foreign to foreign transactions).

Exam views the net section 482 transfer price adjustment as attributable to adjustments of the consideration paid by US Partnership to ForCorp for the finished Products, as evaluated under the applicable transfer pricing method. Although the transactions between ForCorp and Foreign Subs are relevant to evaluating the arm’s length prices of the transactions between US Partnership and ForCorp, the resulting net section 482 transfer price adjustment is attributable to the transactions between US Partnership and ForCorp – not transactions solely between ForCorp and Foreign Subs. Thus, no portion of the adjustment is attributable to transactions solely between foreign corporations within the meaning of section 6662(e)(3)(B)(iii) or foreign to foreign transactions within the meaning Treas. Reg. § 1.6662-6(d)(4).

Taxpayer asserts that the net section 482 transfer price adjustment consists of two distinct adjustments: (1) an adjustment to the transactions between US Partnership and ForCorp and (2) an adjustment to the transactions between ForCorp and Foreign Subs. Taxpayer asserts that section 6662(e)(3)(B)(iii) and Treas. Reg. § 1.6662-6(d)(4) specifically exclude the latter adjustment from being subject to or giving rise to a penalty. The basis for Taxpayer’s view is unclear. The record clearly indicates that the “inter-company transaction giving rise to the proposed transfer price adjustments relates to [US Partnership’s] purchase of [finished Products] from [ForCorp].”⁶ Although

⁵ See memorandum re : IRC Section 6662(h) penalty dated _____, page 4 (emphasis added).

⁶ See Form 886-A re: Section 6662(e) gross valuation misstatement penalties, page 2.

ForCorp's cost of goods sold, which includes the cost of merchandise acquired from Foreign Subs, affected the operating profits of ForCorp evaluated under the CPM, this does not mean that the section 482 adjustment to the prices that US Partnership paid to ForCorp constitute adjustments to foreign-to-foreign transactions.⁷ If Exam had been able to apply the comparable uncontrolled price ("CUP") method under Treas. Reg. § 1.482-3(b) as the best method to determine the arm's length price for the finished Products purchased by US Partnership from ForCorp, the consideration charged in the transactions between ForCorp and Foreign Subs would be irrelevant. In other words, in the CUP context, the transactions between ForCorp and Foreign Subs would have no direct bearing on the net section 482 transfer price adjustment with respect to the transactions between US Partnership and ForCorp. We see no reason why application of one specified method as opposed to another should produce different results.

Existing guidance on the foreign-to-foreign transaction exclusion consists of an example in the legislative history of section 6662(e)⁸ and another example in Treas. Reg. § 1.6662-6(d)(6)(Example 3). Both examples involve adjustments to transactions solely between controlled foreign corporations, where the effect of the adjustment is an inclusion of subpart F income by a U.S. shareholder. In these examples, the U.S. taxpayer is not directly involved in the transactions that give rise to the increase in taxable income. Rather, the increase in taxable income is a by-product of the allocation under section 482.

In contrast, the increase in U.S. taxable income and the allocation under section 482 are one and the same in the instant case. The dispute between Taxpayer and Exam centers on whether US Partnership paid ForCorp an arm's length price for the finished Products. The transactions between ForCorp and Foreign Subs are clearly relevant in determining the net section 482 transfer price adjustment, but they are not, in of themselves, part of the net section 482 transfer price adjustment. As compared to the examples, Taxpayer in this case is directly involved in the controlled transactions that gave rise to the increase in taxable income. Thus, the net section 482 transfer price adjustment in the instant case is not attributable to transactions solely between foreign corporations, but rather is attributable to transactions solely between US Partnership and ForCorp. Taxpayer cannot invoke the "solely between foreign corporations" standard of section 6662(e)(3)(B)(iii) by disregarding that US Partnership is the source of the net section 482 transfer price adjustment.

⁷ Taxpayer's view is flawed. The net section 482 transfer price adjustment of \$X in this case relates solely to the transactions between US Partnership and ForCorp. Taxpayer, however, mistakenly believes that \$X is the sum of adjustments arising from all transactions, both those between US Partnership and ForCorp and those between ForCorp and Foreign Subs. To the contrary, if Exam had asserted (which it did not) adjustments related to the transactions between ForCorp and Foreign Subs, then the net section 482 transfer price adjustment would be \$X+\$Y.

⁸ See H. Conf. Rep. No. 101-964, 1991-2 C.B. 580.

We conclude that on the facts described above, none of the increase in U.S. taxable income resulting from the allocation under section 482 is attributable to transactions solely between foreign corporations within the meaning of section 6662(e)(3)(B)(iii) or foreign to foreign transactions within the meaning Treas. Reg. § 1.6662-6(d)(4).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call the branch at (202) 435-5265 if you have any further questions.

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