

LB&I International Practice Service Transaction Unit

Shelf		Business Outbound		
Volume	1	Outbound Income Shifting	UIL Code	9411
Part	1.5	Sales or Leases of Tangible Property/Goods	Level 2 UIL	9411.05
Chapter	1.5.1	Sales or Leases of Tangible Property - Outbound	Level 3 UIL	N/A
Sub-Chapter	N/A	N/A		

Unit Name	Sale of Tangible Goods from a CFC to a USP – CUP Method
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Document Control Number (DCN)	ISO/9411.05_01(2013)
Date of Last Update	09/08/2014

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Issue and Transaction Overview

Sale of Tangible Goods from a CFC to a USP – CUP Method

The arm's length standard governs transactions between related parties, such as sales of tangible goods between controlled parties. Manufacturing operations are often established in low-tax countries and operated by a member of the controlled group, such as a Controlled Foreign Corporation (CFC), in these low-tax countries. Low tax countries may be countries with a lower tax rate or may offer a tax holiday for manufacturing operations. CFC will sell tangible goods to other members of the controlled group, such as a US entity. The price at which the tangible goods are sold between the controlled parties is the transfer price. The transfer price is recorded as income (sales revenue) to the CFC and expense (cost of goods sold) to the controlled US purchaser of the tangible goods.

Comparable Uncontrolled Price ("CUP") method is a transactional method used to evaluate whether the price of a transaction is arm's length. The CUP method considers the price of comparable transactions between uncontrolled third parties, dealing at arm's length, to judge whether the price between controlled parties is performed at arms length. If the price charged exceeds an arm's length price, then the excess profits are shifted to the CFC. CUP is one allowable method prescribed in the 482 Regulations to determine if pricing is performed at arm's length. This method may be the Best Method under the facts in this example. Consultation with economists and industry/outside experts is often necessary to develop CUP issues.

This unit will focus on what are commonly referred to as "outbound transactions". Generally, outbound transactions involve a United States Parent (USP) doing business with a foreign controlled entity, oftentimes a CFC. While an outbound transaction may involve any type of transaction, this International Practice Service (IPS) unit will focus on the sale of tangible goods from a CFC to its USP.

While this example utilizes a CFC in a low tax country, transfer pricing issues, including the use of the CUP transfer pricing methodology, can also result with CFCs in non low tax countries as well.

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Transaction and Fact Pattern

Sale of Tangible Goods from a CFC to a USP – CUP Method

Diagram of Transaction	Facts
<p>The diagram illustrates the transaction flow. It features three boxes: a white box for 'USP', a blue box for 'CFC (Low Tax Country)', and a white box for 'Uncontrolled Third Party'. A green arrow curves from the CFC box to the USP box, with the text 'Sale of Manufactured Tangible Goods' written vertically to its left. A second green arrow curves from the CFC box to the Uncontrolled Third Party box, with the text 'Sale of Manufactured Tangible Goods' written diagonally below it.</p>	<p><u>Facts:</u></p> <ul style="list-style-type: none"> ▪ CFC is located in a low-tax country. ▪ CFC manufactures tangible goods. Tangible goods are sold to USP and to Uncontrolled Third Party. <p><u>USP:</u></p> <ul style="list-style-type: none"> ▪ USP purchases tangible goods from CFC. ▪ Purchase price does not include freight and duty costs – USP pays these separately. ▪ USP settles its intercompany account payables with the CFC in 90 days. ▪ USP assumes risk of defective products (CFC does not provide a warranty on products sold to USP). <p><u>Uncontrolled Third Party:</u></p> <ul style="list-style-type: none"> ▪ Uncontrolled Third Party purchases tangible goods from CFC. ▪ Uncontrolled Third Party's price includes cost of freight and duty. ▪ CFC invoices Uncontrolled Third Party with payment terms of net 30, which requires payment of the invoice within 30 days. ▪ CFC offers a warranty on products sold to Uncontrolled Third Party.

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Effective Tax Rate Overview

Sale of Tangible Goods from a CFC to a USP – CUP Method

ETR of Company

The statutory corporate tax rate (“corporate tax rate”) is the tax rate imposed on taxable income of corporations. There are countries with significantly lower corporate tax rates than the US corporate tax rate. For financial reporting purposes, a multinational corporation reports its worldwide tax expense in its income statement. The effective tax rate (“ETR”) is a measure of the percentage of worldwide tax expense to the multinational corporation’s worldwide income. Lowering the worldwide tax expense increases the net income of a corporation. A multinational with an ETR lower than the US tax rate has income taxed in countries with lower tax rates. When a CFC charges a higher than arm’s length price for tangible goods, USP incurs excessive cost of goods sold, and the CFC seller recognizes excessive sales revenue. In effect, the excess profits from the sale of tangible goods are shifted to the CFC. These profits would be taxed at the CFC’s lower foreign country tax rate, resulting in a lower ETR for the company.

ETR Impact of Adjustment

If the transfer price for tangible goods charged by the CFC to the USP is more than the arm’s length price, then the USP will have excessive cost of goods sold reported in the US and, consequently, will have underreported its US taxable income. Conversely, the CFC sales revenue will be higher than appropriate, increasing the CFC’s income. This effectively shifts income from the US to the low-tax CFC. The reduction in the worldwide tax expense is the difference between the higher US tax rate and the lower Foreign Country tax rate, as applied to the excess profits amount. This reduction also lowers the corporation’s ETR. Exam adjustments to decrease the transfer price charged by the CFC to USP would allocate profits back to USP, usually resulting in a higher ETR.

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Summary of Potential Issues

Sale of Tangible Goods from a CFC to a USP – CUP Method

<u>Issue 1</u>	Are the controlled and uncontrolled transactions comparable?
<u>Issue 2</u>	Can reliable adjustments be made to account for the differences?

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All Issues, Step 1: Initial Factual Development

Sale of Tangible Goods from a CFC to a USP – CUP Method

Taxpayers may pay higher prices to CFCs for the purchase of tangible goods in order to shift income outside the United States. It is important to establish the facts and supporting documentation that substantiates that CUP is the Best Method for establishing transfer prices between controlled parties.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ What type of product is being sold to USP? ▪ Are there comparable goods being sold to or purchased from the Uncontrolled Third Party that are the same or similar to the goods in this transaction? ▪ What are the terms of the sales of goods in this transaction as well as in the transactions with the Uncontrolled Third Party? ▪ Are profitability ratios dramatically different between the USP and the CFC that might suggest profit shifting? 	<p><i>Request and/or Review the following:</i></p> <ul style="list-style-type: none"> ▪ Transfer Pricing Studies ▪ Organizational Chart ▪ Contracts ▪ Intercompany Agreements ▪ Invoices ▪ Functional Analysis ▪ Taxpayer's Financial Statements ▪ Transfer Pricing Roadmap 	
<ul style="list-style-type: none"> ▪ Does Form 5471 of the CFC reflect a large volume of sales to the USP? 	<ul style="list-style-type: none"> ▪ Form 5471 Information Return of U.S. Persons With Respect to Certain Foreign Corporations, Sch M 	
<ul style="list-style-type: none"> ▪ Does the Form 5471 of the CFC reflect a higher than expected profit margin? 	<ul style="list-style-type: none"> ▪ Form 5471, Schedule C 	


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Issue 1, Step 2: Review Potential Issues

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 1

Are the controlled and uncontrolled transactions comparable?

Explanation of Issue	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The CUP method evaluates whether the price charged for the tangible goods in a controlled transaction is arm's length by comparing it to the price charged in a comparable uncontrolled transaction. The similarity of products will be the most important factor in determining comparability. Comparability will also be affected by factors, such as functions performed, risks assumed, economic conditions, and contractual terms. Comparability depends on close similarity with respect to each factor. ▪ The determination of whether CUP is the best method is dependent on the degree of comparability between the controlled and uncontrolled transaction as well as the completeness and accuracy of the data and assumptions used. ▪ Determine whether the goods sold in the controlled transaction and the comparable uncontrolled transaction are truly comparable. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-3(b)(1) ▪ Treas. Reg. 1.482-3(b)(2)(ii)(A) ▪ Treas. Reg. 1.482-3(b)(2)(iii) ▪ Treas. Reg. §1.482-1(c) ▪ Treas. Reg. §1.482-1(d) ▪ IPS Unit: Comparability Analysis for Tangible Goods Transactions Inbound DCN: ISI/9422.07_01 thru _06(2013) 	
 CONSULTATION: Consult with an Engineer to review physical product comparability. Consult with an Economist and/or Industry Specialist to review CUP and quantification of comparability adjustments.	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-3(b)(4) 	

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Issue 1, Step 3: Additional Factual Development

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 1

Are the controlled and uncontrolled transactions comparable?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ What is the source of data for the taxpayer's CUP? Is the comparable price a reflection of an uncontrolled price? Was it based on average prices, rather than actual transactional data? Were there extraordinary circumstances in either the controlled or uncontrolled transaction price? 	<p><i>Request and/or Review the following:</i></p> <ul style="list-style-type: none"> ▪ Transfer Pricing Studies ▪ Contracts / Invoices ▪ Intercompany Agreements ▪ Annual Reports ▪ Product Literature ▪ Website research ▪ Transfer Pricing Roadmap 	
<ul style="list-style-type: none"> ▪ What are the differences in the physical characteristics and quality of the tangible goods in the controlled and uncontrolled transaction? 		

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

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 1

Are the controlled and uncontrolled transactions comparable?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> Is one of the differences between the products the inclusion of intangible assets associated with one or more of the products? The inclusion of intangibles will change the pricing of the transaction. Look for discussions of potential intangible assets included with either the controlled or the uncontrolled transaction (such as branded goods vs. generic goods) in any of the resources listed here. 	<ul style="list-style-type: none"> Transfer Pricing Studies Contracts / Invoices Intercompany Agreements Annual Reports Product Literature Product website research Transfer Pricing Roadmap IPS Unit: Comparability Analysis for Tangible Goods Transactions Inbound, Property or Services discusses embedded intangibles 	

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

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 1

Are the controlled and uncontrolled transactions comparable?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> Does the controlled transaction involve the provision of services that would render any uncontrolled transaction not comparable (such as training or warranty services)? The inclusion of additional services will change the pricing of the transaction. Review the resources listed here to determine if any services will be performed in either the controlled or the uncontrolled transactions that will render them not comparable. If the service is immaterial, it may not have an impact, but each transaction should be evaluated on its own facts and circumstances. 	<ul style="list-style-type: none"> Transfer Pricing Studies Contracts / Invoices Intercompany Agreements Annual Reports Product Literature Product website research Transfer Pricing Roadmap IPS Unit: Comparability Analysis for Tangible Goods Transactions Inbound, discusses embedded services 	

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

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 1

Are the controlled and uncontrolled transactions comparable?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Are there additional differences between the controlled and uncontrolled transaction? Review the resources listed here for differences in geographic market, product description, level of competitors, and advantages of taxpayer that might suggest intangibles present. Other differences to account for, include; <ul style="list-style-type: none"> – form of consideration – foreign currency risk – inventory risk – warranty terms – purchase/sales volume – credit terms and credit and collection risks – transportation terms – rights to updates and revisions – termination rights, renegotiation rights – level and size of market, and/or – economic condition of industry and market. 	<ul style="list-style-type: none"> ▪ Transfer Pricing Studies ▪ Contracts / Invoices ▪ Intercompany Agreements ▪ Annual Reports ▪ Product Literature ▪ Product website research ▪ Transfer Pricing Roadmap ▪ Security and Exchange Commission (“SEC”) Filings ▪ IRM 4.61.3.4.5 – How to Develop a Section 482 Case – Transfers of Tangible Property 	


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Issue 1, Step 4: Develop Arguments

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 1

Are the controlled and uncontrolled transactions comparable?

Explanation of Approach	Resources	6103 Protected Resources
<p>The argument for whether the CUP is truly a comparable transaction is based on the facts and circumstances of the specific case.</p> <p>You need to establish that the uncontrolled transaction is truly a comparable by looking at all of the factors discussed in Treas. Reg. 1.482-3(b)(2). Your analysis should contain an in-depth review of all of the factors that impact the comparability of the controlled and uncontrolled transactions in your case. The controlled and uncontrolled transactions must be considered the same or similar in order to be considered comparable. Similarity is key in order for the CUP method to be reliable.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-3(b)(2)(ii)(A) ▪ Treas. Reg. 1.482-3(b)(2)(iii) ▪ Treas. Reg. §1.482-1(c) and (d) 	
 <p>DECISION POINT: Need to ascertain whether the controlled and uncontrolled transaction are sufficiently similar for comparison. If so, you will need to ascertain whether the starting point for the comparable price is valid. If the controlled and uncontrolled transactions have been determined to be comparable, the next step is to determine if all material adjustments have been made.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-3(b)(2)(ii)(A) 	

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Issue 2, Step 2: Review Potential Issues

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 2

Can reliable adjustments be made to account for the differences?

Explanation of Issue	Resources	6103 Protected Resources
<p>Once the differences between the controlled and uncontrolled transactions have been identified, comparability between the transactions depends on close similarity with respect to each factor. Adjustments would be required for each of the material differences in order for the CUP method to be considered a reliable method.</p> <p>The data and assumptions used to derive the comparability adjustments should be evaluated with respect to reliability and reasonableness.</p> <p>If adjustments cannot be quantified, the CUP would not be a reliable method and would not be considered the best method.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-3: ▪ Treas. Reg. 1.482-3(b)(2)(ii)(A) ▪ Treas. Reg. 1.482-3(b)(2)(ii)(B) ▪ Treas. Reg. 1.482-3(b)(2)(iii) ▪ IPS Unit: Comparability Analysis for Tangible Goods Transactions Inbound, ISI/9422.07_01 thru _06(2013) 	



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

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 2

Can reliable adjustments be made to account for the differences?

Explanation of Issue	Resources	6103 Protected Resources
 <p>DECISION POINT: Are there material and significant differences that must be adjusted to make the uncontrolled transaction comparable? Can these significant and material adjustments be truly quantified? If reliable adjustments cannot be made, the CUP may not be the best method and other allowable pricing methods should be considered.</p>	<ul style="list-style-type: none"> Treas. Reg. 1.482-3(b)(2)(ii)(A) 	
 <p>CONSULTATION: Consult with an Engineer to quantify differences in physical product. Consult with an Economist and/or Industry Specialist to quantify comparability adjustments and review materiality of adjustments.</p>	<ul style="list-style-type: none"> Treas. Reg. 1.482-3(b)(2)(ii)(B) Treas. Reg. 1.482-3(b)(4) 	

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Issue 2, Step 3: Additional Factual Development

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 2

Can reliable adjustments be made to account for the differences?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Can identifiable differences be quantified reliably and can adjustments be made to make the transactions truly comparable? Review all resources available in efforts to quantify, or place a value on, the specific differences between the controlled transactions and the uncontrolled transactions. ▪ Is the data used to make the adjustments reliable? ▪ Are the assumptions used to make the adjustments sound and reasonable? 	<p><i>Request and/or Review the following:</i></p> <ul style="list-style-type: none"> ▪ Transfer Pricing Studies ▪ Contracts / Invoices ▪ Intercompany Agreements ▪ Annual Reports ▪ Product Literature ▪ Website research ▪ Adjustment Analysis workpapers 	

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

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 2

Can reliable adjustments be made to account for the differences?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Are there additional adjustments that have not been identified? ▪ Can these adjustments be quantified? ▪ If there are material differences in the controlled and uncontrolled transactions that have not been adjusted, will adjustments render the controlled and uncontrolled transactions sufficiently comparable? 	<p><i>Request and/or Review the following:</i></p> <ul style="list-style-type: none"> ▪ Organizational charts ▪ Transfer Pricing Studies ▪ Contracts / Invoices ▪ Intercompany Agreements ▪ Annual Reports ▪ Product Literature ▪ Website research 	


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Issue 2, Step 4: Develop Arguments

Sale of Tangible Goods from a CFC to a USP – CUP Method

Issue 2

Can reliable adjustments be made to account for the differences?

Explanation of Approach	Resources	6103 Protected Resources
<p>If there are identifiable differences between the comparables, determine whether reliable adjustments can be made to the uncontrolled transaction.</p> <p>Due to the heavy reliance on comparability of the controlled and uncontrolled transaction when utilizing the CUP method deficiencies in data or assumptions greatly diminish the reliability and use of the CUP method. The reliability of the CUP method increases as the completeness and accuracy of the data and assumptions increase.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-3(b)(2)(ii)(B) ▪ Treas. Reg. 1.482-3(b)(2)(iii) ▪ Treas. Reg. §1.482-1(c) ▪ Treas. Reg. §1.482-1(d) 	
 <p>DECISION POINT: Ascertain whether adjustments are able to be quantified. Ascertain reliability of the data used and assumptions made in the adjustments to determine whether CUP is reliable.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.482-3(b)(2)(ii) ▪ Treas. Reg. 1.482-3(b)(2)(iii) 	

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Training and Additional Resources

Chapter 1.5.1 Sales or Leases of Tangible Property - Outbound

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ FY2012 Transfer Pricing Introduction to 482. ▪ FY2013 IRC 482 Overview. 	<ul style="list-style-type: none"> ▪ Transfer Pricing Introduction to 482 (QRP785958) ▪ IBC IRC 482 OVERVIEW 50767 (HLL028040)
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 ▪ IRM 4.43.1.5.3 Product Pricing by the Controlled Foreign Corporation (CFC) or the Foreign Controlled Corporation (FCC) 	<ul style="list-style-type: none"> ▪ Transfer Pricing Functional Analysis Questionnaire ▪ Checklist – IRC § 482 (Transfer Pricing) ▪ IRM 4.61.3 - Development of IRC 482 Issues ▪ IRM 4.43.1.16.1 Product Pricing by the CFC or the FCC

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Issue Toolkits (cont'd)	<ul style="list-style-type: none"> ▪ Economists - @ Issue...Adjusted CUP ▪ On-the-Job Training for International Examiners (IE) - Development of Transfer Pricing Sec. 482 Issues 	<ul style="list-style-type: none"> ▪ Economists - @ Issue...Adjusted CUP ▪ OJT for IEs - Development of Transfer Pricing Sec 482 Issues
Podcasts / Videos	<ul style="list-style-type: none"> ▪ FY 11 CPE – Day 2 - Transfer Pricing Track - Risk, Comparability & Best Method 	
Other Training Materials	<ul style="list-style-type: none"> ▪ International Examiner Phase II Training, Module E-1, Overview of IRC 482 ▪ International Examiner Phase II Training, Lesson 4, Sales of Tangible Property ▪ Transfer Pricing Roadmap ▪ Bittker and Lokken, <i>Fundamentals of International Taxation</i>, Chapter 79: Reallocation of Income and Deductions ▪ The Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines 	<ul style="list-style-type: none"> ▪ Overview of IRC 482 ▪ Sales of Tangible Property ▪ Transfer Pricing Roadmap ▪ Bittker and Lokken, <i>Fundamentals of International Taxation</i>, Chapter 79 ▪ OECD Transfer Pricing Guidelines

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Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation
CUP	Comparable Uncontrolled Price
ETR	Effective Tax Rate
IBC	International Business Compliance
IPN	International Practice Network
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
LB&I	Large Business & International
NOPA	Notice of Proposed Adjustment
OECD	The Organization for Economic Co-operation and Development
TPO	Transfer Pricing Operations
UIL	Uniform Issus List
USP	United States Parent

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Comparable Profits Method (CPM)	9422.07	IPS Unit: CPM Simple Distributor Inbound, ISI/9422.07_07(2013)
Functional Analysis	9422.07	IPS Unit Coming Soon
Contractual Terms	9422.07	IPS Unit Coming Soon
Risks	9422.07	IPS Unit Coming Soon
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Standards of Comparability	9422.07	IPS Unit: Comparability Analysis for Tangible Goods Transactions Inbound, ISI/9422.07_01 thru _06(2013)
Standards of Comparability	9422.07	IPS Unit: Comparability Analysis for Tangible Goods Transactions Outbound, ISO/PUO/V_1_01(2014)
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Penalties-Gross	9560.12	IPS Unit Coming Soon