

Internal Revenue Service  
**memorandum**

CC:INTL:Br5  
ESHENDALMAN

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to: Paul Chmiel, IFASP  
Office of the Assistant Commissioner (International)

from: Grace Perez-Navarro, Special Counsel CC:INTL  
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subject: Commensurate with income standard under section 482 of the  
Internal Revenue Code

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This memorandum relates to a request for technical assistance on whether the commensurate with income standard in the new transfer pricing Income Tax Regulations under section 482 prohibits the use of a method that provides a contract manufacturer's return to a licensee of non-routine intangibles. This memorandum concludes the commensurate with income standard requires that the division of income between the related parties reasonably reflect the relative economic activity undertaken by each. Accordingly, only where a taxpayer is performing the functions and assuming the risks of a contract manufacturer should the taxpayer's efforts generate a contract manufacturer's return.

Section 482 provides that in any case of 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 interest, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. As part of the Tax Reform Act of 1986, Congress added to section 482 a provision that in the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

The Conference Report on the 1986 Act states that the objective of this new provision was to ensure that the division of income between related parties reasonably reflect the relative economic activity undertaken by each. 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-137-150 (1986), 1986-3 (Vol. 4) C.B. 637.

The Joint Committee Report on the 1986 Act gives further insight into the intent of the addition of the commensurate with income standard to section 482. Like the Conference Report, the Joint Committee Report explains that the commensurate with income standard was added to fulfill the objective that the division of income between related parties reasonably reflect the relative economic activity undertaken by each. Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. 1015 (1986). However, the Joint Committee Report continues:

In requiring that payments be commensurate with the income stream, the Act does not intend to mandate the use of the "contract manufacturer" or "cost-plus" methods of allocating income or any other particular method. As under prior law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent upon, or assured by, such related parties' marketing efforts.

Id. at 1016.

Under § 1.482-4(a), the arm's length consideration for the transfer of an intangible determined under this section must be commensurate with the income attributable to the intangible.

Although the commensurate with income standard clearly does not dictate a contract manufacturer return, neither does the standard prohibit such a return. The division of income between related parties must reasonably reflect the relative economic activity undertaken by each, taking into account the facts and circumstances surrounding the transfer of intangible property. In circumstances where a party functions solely as a manufacturer and bears no other risks or responsibilities, such a return may be warranted. Where, however, a party performs functions and bears risks that go beyond those of a contract manufacturer, such as marketing (including the development of marketing intangibles) and sales support, its return must take into account these added functions and risks.

Should you have any questions please feel free to contact Grace Perez-Navarro at (202) 622-3810.