

# APA Training: TPMs

(Excluding Cost Sharing, Financial Services)

June 13, 2001

Russell Kwiat, APA Program

# Agenda

- Best Method Rule
- Tangible Property TPMs
  - CPM
- Intangible Property TPMs
- Services

# Best Method

Question: What Method Should Be Used?

Choices:

- A) The method that results in the greatest amount of taxable income in the U.S.
- B) The method used by the taxpayer for pre-APA years
- C) The “Best Method”
- D) Whatever the taxpayer wants

# Best Method

Question: What Method Should Be Used?

Answer: The “Best Method”

# Best Method

- “Best Method”
  - The method that, under the facts and circumstances, provides the most reliable measure of an arm’s-length result (1.482-1(c)1)
  - No strict hierarchy
  - Should result be reasonable?
    - APA vs. audit

# Best Method

- Reliability Factors
  - Comparability (e.g., industry, functions, risks, contractual terms, market level)
  - Quality of data
  - Reliability of assumptions
  - Sensitivity of results to deficiencies in the data and assumptions

# Best Method

- Comparability Factors
  - Functions
  - Contractual terms
  - Risks
  - Economic conditions
  - Property or services

# Best Method

- Basic Functions
  - Manufacturing
  - Distribution
  - Marketing
  - R&D
  - Procurement
  - Administrative services



# Best Method

- Contractual Terms
  - Respected if consistent with economic substance
  - Authority to impute an agreement

# Best Method: Aggregation

- Does it provide an advantage compared to setoffs?
- Does it provide justification for a “big tent” approach?

# Tangible Property

- Tangible Property
  - Transactional
    - CUP (1.482-3(b))
    - Resale Price Method (1.482-3(c))
      - Gross margin of a distributor
    - Cost Plus Method (1.482-3(d))
      - Gross margin of a manufacturer
  - Profit Based
    - CPM (1.482-5)
    - Profit Split (1.482-6)
  - Unspecified Methods

# Tangible Property

## Transactional Data

- Internal
  - Transactions between taxpayer and 3rd parties
- External
  - Transactions between two third parties

# Transfer Pricing Methods

TPMs for Tangible and Intangible Property (through 1999)	
CUP	5%
CUT	6%
Resale Price	5%
Cost Plus	5%
CPM	59%
Comparable Profit Split	1%
Residual Profit Split	7%
Other Profit Split	5%
Agreed royalty (fixed rate)	4%
Sliding royalty (based on OM or R&D)	2%
Other	3%
Total	100%

# Tangible Property

- CUP
  - High degree of comparability required  
(1.482-3(b)(2)(ii))
  - If such comparability achieved then ordinarily the most reliable method
  - May be more difficult to apply prospectively

# Tangible Property

- CPM
  - Focused on operating profit of tested party
  - Most frequently used method
    - Comparability standards lower
    - Data readily available
    - Easy to apply prospectively
  - What do our treaty partners think?
    - Modified resale price

# CPM

- Elements of the CPM
  - Tested Party
  - Comparables
  - Profit level indicator (“PLI”)
    - Return on capital employed (AKA return on assets)
    - Operating margin
      - Cost plus
      - $OM = CP / (1+CP)$ ;  $CP = OM / (1-OM)$
    - Berry ratio
      - Cost plus on operating expenses
  - Adjustments
  - Multiple year analysis
  - Interquartile range
  - Testing
  - Calculation of 482 adjustment



# CPM

- Tested Party
  - Least complex party
  - Does not own value intangibles
  - Not the primary risk taker
    - Allocation of risk considerations
      - Conduct over time
      - Financial capacity
      - Managerial or operational control
  - Beware of tested party data
    - Allocations
    - Double dipping

# CPM

- PLIs:
  - Ratios that measure relationships between profits and costs incurred or resources employed.

# CPM

- PLIs: Theoretical Considerations
  - ROA and variants are standard measurement tools of financial performance
  - Operating Margin is a component of ROA

# CPM: PLIs

Profit Margin      x      Asset Turnover      =      Return on Assets

Op. Profit      x      Net Sales      =      Operating Profit  
Net Sales           Operating Assets           Op. Assets

## Examples

*Mfg.*

6%      x      1x      =      6%

*Dist.*

2%      x      3x      =      6%

# CPM

## PLIs: Theoretical Considerations

Operating margins are meaningful for firms with similar levels of:

- Working capital as a percent of sales;
- Fixed assets as a percent of sales;
- Intangible assets as a percent of sales;
- Risk

# CPM: PLIs

- Limitations to ROA
  - Not all assets are booked
    - Intangibles, human capital, advertising
  - Not all assets have the same risk
  - Measurement Problems
    - Age of assets
    - Owned vs. leased assets
    - (Denominator of OM (i.e., sales) does not have serious measurement problems)

# CPM: PLIs

- Limitations to ROA (cont.)
  - Increased assets implies increased profits
    - Unplanned inventory build up
  - OM directionally correct (generally)
    - Increased sales implies increased profits

# CPM: PLIs

- Return on Capital Employed
  - Reliability increased when:
    - Operating assets play a greater role in generating operating profits
    - Composition of assets of tested party is similar to that of the comparables
    - Don't have difficulty in properly valuing operating assets
- Financial Ratios (Berry Ratio, Operating Margin)
  - Less reliable when there are functional differences
  - For BR need to consider the extent to which composition of operating expenses of tested party is similar to that of the comparables
  - *For BR should SG&A/Sales matter?*
  - *For BR need to address classification issues*



# CPM: PLIs

- Return on Capital Employed
  - When does a taxpayer's operating assets play a greater role in generating operating profit? Greater than what?
  - Evaluating composition of assets
- Financial Ratios
  - Closer functional comparability required (how close?)

# CPM: PLIs

- Tested Party vs. Comparables
  - Operating Expense / Sales
    - Inefficiency vs. more functions
- Number of Comparables
- Manipulation of Intercompany Assets
  - Do intangibles vary in proportion to assets?

## CPM: PLIs

	Comp 1	Comp 2	TP
Sales	100	100	100
COGS	90	82	85.7
Gross Profit	10	18	14.3
Op. Exp.	8	15	12
Op. Profit	2	3	2.3
Gross Margin	10.0%	18.0%	14.3%
Op. Margin	2.0%	3.0%	2.3%
Berry Ratio	1.25	1.20	1.19
Op. Profit/Op. Exp.	25%	20%	19%

# CPM: PLIs

- Is Gross Margin a reliable PLI?
- Why would one advocate the use of a Gross Margin PLI?
- How can we derive an appropriate Gross Margin target?
- What does Gross Margin PLI imply about risk?
- How does the range concept relate to the Gross Margin PLI?

# CPM

- Comparables
  - Proxy comparables
  - Number of comparables
  - Years of analysis

# Intangible Property

- Intangible Property TPMs
  - CUT
  - CPM
  - Profit Split
  - Unspecified Methods

# Intangibles

- An asset that comprises any of the following items and has substantial value independent of the services of any individual
  - Patents, inventions, formulae, processes, designs, patterns, or know-how;
  - Copyrights and literary, musical, or artistic compositions;
  - Trademarks, trade names, or brand names;
  - Franchises, licenses, or contracts;
  - Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
  - Other similar items.
    - Derives value not from its physical attributes but from its intellectual content or other intangible properties

# Intangibles

- Commercially transferable requirement
- Are the following compensable under 482?
  - Workforce in place
  - Going concern
  - Goodwill



# Intangibles

- CUT Requirements
  - Similar products or processes within the same general industry or market
  - Intangibles must have similar profit potential

# Intangibles: Commensurate with Income

- Code amended in 1986
  - “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.”

# Intangibles: Commensurate with Income

- Periodic Adjustments
  - If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each year may be adjusted to ensure that it is commensurate with income

# Commensurate with Income

- Exceptions to Periodic Adjustments
  - Same intangible under substantially same circumstances
  - Profits/savings actually realized by the controlled taxpayer from the exploitation of the intangible in year under examination and all past years is within 80%-120% foreseeable band
  - Extraordinary events (e.g., natural disaster)
  - Five-year period

# Commensurate with Income

- What if there are multiple intangibles?
- Should there be a minimum amount of consideration for the use of intangibles?

# Intangibles

- Ownership
  - Legally protected intangibles
  - Not legally protected intangibles
    - Owner generally the party that bore the greatest share of the costs of development

# Intangibles

- Assistance payment to non owners
  - Routine vs. non routine expenditures

# Intangibles

- “Cheese” examples
  - Example 2: USSub’s marketing expenses are comparable to comparable independent distributors. No allocation
  - Example 3: USSub’s marketing expenses are significantly larger than comps’. No reimbursement from FP. Allocation = FMV of services
  - Example 4: Long term agreement. Therefore, USSub is owner. No allocation.



# Intangibles: Residual Profit Split

- More commonly used when more than one party has valuable nonroutine intangibles.
- Is it a fairer method than one sided methods?

# Intangibles: Residual Profit Split

- **Step I: Allocate income to routine contributions**
- **Step II: Splitting of Residual Profit/Loss**
  - Based on value of contributions of intangible property  
NOT accounted for as a routine contribution
    - External market benchmarks
    - Estimated based on capitalized and amortized IDCs
    - Actual expenditures in recent years

# Intangibles: Residual Profit Split

- Handout Entitled “Example of Residual Profit Split”
- Handout Entitled “Residual Profit Split: Example of Calculation of R&D Stocks”

# Intangibles: Residual Profit Split

- **Use of Capitalized and Amortized IDCs**
  - **Is it reasonable to assume past and future R&D/marketing expenditures are of equal value?**
  - **Requires assumptions regarding:**
    - **Useful life**
    - **Amortization path**

# Intangibles: Profit Split

- **Unspecified Profit Splits used in APAs**
  - Based on operating assets
  - Based on operating expenses

# Intangibles: Profit Split

- **“Rule of Thumb”**

- Uncertainty regarding what split is (e.g., 25/75? 33/67?)
- Uncertainty as to what profits are being split (e.g., total operating profit? incremental operating profit?)
- Is it just a starting point?
- Does it make sense for all intangibles?

# Intangibles: Profit Split

- Handout “Illustration of Royalty Cap of 25% of Profits”

# Intangibles: Profit Split

- **“Rule of Thumb” and Sec. 482 Regs**
  - “... In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The specified method of allocation must be determined under paragraph (c) of this section.”  
(1.482-6(b))



# Services

- Arm's length charge required for services performed for the benefit of a related party
- No charge:
  - If probable benefits so remote that unrelated parties would not charge for services then no charge
  - For duplicative services

# Services

- Non Integral Services
  - Arm's length charge shall be deemed equal to the costs or deductions
    - Indirect costs or deductions should be included
- Integral Services
  - Arm's length charge will include a provision for some profit over total costs and deductions

# Services

- Integral Services (4 factors)
  - Renderer or recipient is engaged in the trade or business of rendering or providing similar services to unrelated parties
  - If the renderer provides services to related parties as one of its principal activities.
    - 25% test creates presumption

# Services

- Integral Services (4 factors)
  - Renderer peculiarly capable and such services are a principal element in the operations of the recipient
  - If the recipient has received the benefit of a substantial amount of services from one or more related parties
    - Costs/deductions of renderer < 25% costs/deductions of recipient

# Services

- Integral Service TPMs
  - Mainly cost plus
- Should Cost Base Include Fully Loaded Costs?

# Transfer-Pricing Methods

- Loans or Advances (1.482-2(a))
- Cost Sharing Arrangements (1.482-7)
- Financial Services
  - Global dealing (Notice 94-40)

# Best Method

- Location Savings
  - Do lower costs of producing in foreign locations result in higher profits?
  - If so, who is entitled to the profits?

# Best Method

- Location Savings
  - Taxpayer's argument: profits should accrue to foreign subsidiary in low cost jurisdiction
  - Assumptions:
    - Costs are lower
    - Cost savings result in higher profits
    - Higher profits should accrue to foreign subsidiary



# CPM

- Captive Round Trip Contract Manufacturer