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A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances. See § 1.482–1(d)(2) (Standard of comparability). Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in § 1.482–1(c).

(2) *Arm's length methods*—(i) *Methods.* Sections 1.482–2 through 1.482–6 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result.

(ii) *Selection of category of method applicable to transaction.* The methods listed in § 1.482–2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly, the method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result. But see § 1.482–1(f)(2)(i) (Aggregation of transactions). In addition, other applicable provisions of the Code may affect the characterization of a transaction, and therefore affect the methods applicable under section 482. See for example section 467.

(c) *Best method rule*—(1) *In general.* The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result. See § 1.482–8 for examples of the application of the best method rule.

(2) *Determining the best method.* Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. These factors are explained in paragraphs (c)(2)(i), (ii), and (iii) of this section.

(i) *Comparability.* The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in § 1.482–1(d)(3) (Factors for determining comparability), and after making adjustments for differences, as described in § 1.482–1(d)(2) (Standard of comparability). As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced. In

addition, if adjustments are made to increase the degree of comparability, the number, magnitude, and reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. See § 1.482–3(b)(2)(ii)(A). An analysis will be relatively less reliable, however, as the uncontrolled transactions become less comparable to the controlled transaction.

(ii) *Data and assumptions.* Whether a method provides the most reliable measure of an arm's length result also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled transactions. These factors are discussed in paragraphs (c)(2)(ii) (A), (B), and (C) of this section.

(A) *Completeness and accuracy of data.* The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. For example, the completeness and accuracy of data will determine the extent to which it is possible to identify differences between the controlled and uncontrolled transactions, and the reliability of adjustments that are made to account for such differences. An analysis will be relatively more reliable as the completeness and accuracy of the data increases.

(B) *Reliability of assumptions.* All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable. For example, adjustments for differences in payment terms between controlled and uncontrolled transactions may be based on the assumption that at arm's length such differences would lead to price differences that reflect the time value of money. Although selection of the appropriate interest rate to use in making such adjustments involves some judgement, the economic analysis on which the assumption is based is relatively sound. Other assumptions may be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method.

(C) *Sensitivity of results to deficiencies in data and assumptions.* Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake the same or similar functions, employ similar resources, and bear similar risks is particularly important. Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income, and assets may be of particular importance. Therefore, a difference between the controlled and uncontrolled transactions for which an accurate adjustment cannot be made may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method analysis, while differences in product characteristics will ordinarily have a greater effect on a comparable uncontrolled price method analysis than on a comparable profits method analysis.

(iii) *Confirmation of results by another method.* If two or more methods produce inconsistent results, the best

method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

(d) *Comparability*—(1) *In general.* Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors). While a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Such factors include the following—

(i) Functions;

(ii) Contractual terms;

(iii) Risks;

(iv) Economic conditions; and

(v) Property or services.

(2) *Standard of comparability*. In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this section, a material difference is one that would materially affect the measure of an arm's length result under the method being applied. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced. Generally, such adjustments must be made to the results of the uncontrolled comparable and must be based on commercial practices, economic principles, or statistical analyses. The extent and reliability of any adjustments will affect the relative reliability of the analysis. See § 1.482–1(c)(1) (Best method rule). In any event, unadjusted industry average returns themselves cannot establish arm's length results.

(3) *Factors for determining comparability*. The comparability factors listed in § 1.482–1(d)(1) are discussed in this section. Each of these factors must be considered in determining the degree of comparability between transactions or taxpayers and the extent to which comparability adjustments may be necessary. In addition, in certain cases involving special circumstances, the rules under paragraph (d)(4) of this section must be considered.

(i) *Functional analysis.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include—

(A) Research and development;

(B) Product design and engineering;

(C) Manufacturing, production and process engineering;

(D) Product fabrication, extraction, and assembly;

(E) Purchasing and materials management;

(F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;

(G) Transportation and warehousing; and

(H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

(ii) *Contractual terms*—(A) *In general.* Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include—

(*1*) The form of consideration charged or paid;

(*2*) Sales or purchase volume;

(*3*) The scope and terms of warranties provided;

(*4*) Rights to updates, revisions or modifications;

(*5*) The duration of relevant license, contract or other agreements, and termination or renegotiation rights;

(*6*) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and

(*7*) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required even if no interest would be allocated or imputed under § 1.482–2(a) or other applicable provisions of the Internal Revenue Code or regulations.

(B) *Identifying contractual terms*—(*1*) *Written agreement.* The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (see, for example, § 1.482–4(f)(3) (Ownership of intangible property)). If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

(*2*) *No written agreement.* In the absence of a written agreement, the district director may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights (see, for example, § 1.482–4(f)(3) (Ownership of intangible property)). For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the district director may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it. See UCC 1–205. For example, unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods. See UCC 2–310.

(C) *Examples.* The following examples illustrate this paragraph (d)(3)(ii).

Example 1—Differences in volume. USP, a United States agricultural exporter, regularly buys transportation services from FSub, its foreign subsidiary, to ship its products from the United States to overseas markets. Although FSub occasionally provides transportation services to URA, an unrelated domestic corporation, URA accounts for only 10% of the gross revenues of FSub, and the remaining 90% of FSub's gross revenues are attributable to FSub's transactions with

USP. In determining the degree of comparability between FSub's uncontrolled transaction with URA and its controlled transaction with USP, the difference in volumes involved in the two transactions and the regularity with which these services are provided must be taken into account if such difference would have a material effect on the price charged. Inability to make reliable adjustments for these differences would affect the reliability of the results derived from the uncontrolled transaction as a measure of the arm's length result.

Example 2—Reliability of adjustment for differences in volume. (i) FS manufactures product XX and sells that product to its parent corporation, P. FS also sells product XX to uncontrolled taxpayers at a price of $100 per unit. Except for the volume of each transaction, the sales to P and to uncontrolled taxpayers take place under substantially the same economic conditions and contractual terms. In uncontrolled transactions, FS offers a 2% discount for quantities of 20 per order, and a 5% discount for quantities of 100 per order. If P purchases product XX in quantities of 60 per order, in the absence of other reliable information, it may reasonably be concluded that the arm's length price to P would be $100, less a discount of 3.5%.

(ii) If P purchases product XX in quantities of 1,000 per order, a reliable estimate of the appropriate volume discount must be based on proper economic or statistical analysis, not necessarily a linear extrapolation from the 2% and 5% catalog discounts applicable to sales of 20 and 100 units, respectively.

Example 3—Contractual term imputed from economic substance. (i) USD, a United States corporation, is the exclusive distributor of products manufactured by FP, its foreign parent. The FP products are sold under a tradename that is not known in the United States. USD does not have an agreement with FP for the use of FP's tradename. For Years 1 through 6, USD bears marketing expenses promoting FP's tradename in the United States that are substantially above the level of such expenses incurred by comparable distributors in uncontrolled transactions. FP does not directly or indirectly reimburse USD for its marketing expenses. By Year 7, the FP tradename has become very well known in the market and commands a price premium. At this time, USD becomes a commission agent for FP.

(ii) In determining USD's arm's length result for Year 7, the district director considers the economic substance of the arrangements between USD and FP throughout the course of their relationship. It is unlikely that at arm's length, USD would incur these above-normal expenses without some assurance it could derive a benefit from these expenses. In this case, these expenditures indicate a course of conduct that is consistent with an agreement under which USD received a long-term right to use the FP tradename in the United States. Such conduct is inconsistent with the contractual arrangements between FP and USD under which USD was merely a distributor, and later a commission agent, for FP. Therefore, the district director may impute an agreement between USD and FP under which USD will retain an appropriate portion of the price premium attributable to the FP tradename.

(iii) *Risk*—(A) *Comparability*. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include—

(*1*) Market risks, including fluctuations in cost, demand, pricing, and inventory levels;

(*2*) Risks associated with the success or failure of research and development activities;

(*3*) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates;

(*4*) Credit and collection risks;

(*5*) Product liability risks; and

(*6*) General business risks related to the ownership of property, plant, and equipment.

(B) *Identification of taxpayer that bears risk.* In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the provisions of § 1.482–1(d)(3)(ii)(B) (Identifying contractual terms). Thus, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance. In considering the economic substance of the transaction, the following facts are relevant—

(*1*) Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is

changed, whether the relevant contractual arrangements have been modified accordingly;

(*2*) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(*3*) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

(C) *Examples.* The following examples illustrate this paragraph (d)(3)(iii).

Example 1. FD, the wholly-owned foreign distributor of USM, a U.S. manufacturer, buys widgets from USM under a written contract. Widgets are a generic electronic appliance. Under the terms of the contract, FD must buy and take title to 20,000 widgets for each of the five years of the contract at a price of $10 per widget. The widgets will be sold under FD's label, and FD must finance any marketing strategies to promote sales in the foreign market. There are no rebate or buy back provisions. FD has adequate financial capacity to fund its obligations under the contract under any circumstances that could reasonably be expected to arise. In Years 1, 2 and 3, FD sold only 10,000 widgets at a price of $11 per unit. In Year 4, FD sold its entire inventory of widgets at a price of $25 per unit. Since the contractual terms allocating market risk were agreed to before the outcome of such risk was known or reasonably knowable, FD had the financial capacity to bear the market risk that it would be unable to sell all of the widgets it purchased currently, and its conduct was consistent over time, FD will be deemed to bear the risk.

Example 2. The facts are the same as in *Example 1,* except that in Year 1 FD had only $100,000 in total capital, including loans. In subsequent years USM makes no additional contributions to the capital of FD, and FD is unable to obtain any capital through loans from an unrelated party. Nonetheless, USM continues to sell 20,000 widgets annually to FD under the terms of the contract, and USM extends credit to FD to enable it to finance the purchase. FD does not have the financial capacity in Years 1, 2 and 3 to finance the purchase of the widgets given that it could not sell most of the widgets it purchased during those years. Thus, notwithstanding the terms of the contract, USM and not FD assumed the market risk that a substantial portion of the widgets could not be sold, since in that event FD would not be able to pay USM for all of the widgets it purchased.

Example 3. S, a Country X corporation, manufactures small motors that it sells to P, its U.S. parent. P incorporates the motors into various products and sells those products to uncontrolled customers in the United States. The contract price for the motors is expressed in U.S. dollars, effectively allocating the currency risk for these transactions to S for any currency fluctuations between the time the contract is signed and payment is made. As long as S has adequate financial capacity to bear this currency risk (including by hedging all or part of the risk) and the conduct of S and P is consistent with the terms of the contract (i.e., the contract price is not adjusted to reflect exchange rate movements), the agreement of the parties to allocate the exchange risk to S will be respected.

Example 4. USSub is the wholly-owned U.S. subsidiary of FP, a foreign manufacturer. USSub acts as a distributor of goods manufactured by FP. FP and USSub execute an agreement providing that FP will bear any ordinary product liability costs arising from defects in the goods manufactured by FP. In practice, however, when ordinary product liability claims are sustained against USSub and FP, USSub pays the resulting damages. Therefore, the district director disregards the contractual arrangement regarding product liability costs between FP and USSub, and treats the risk as having been assumed by USSub.

(iv) *Economic conditions.* Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include—

(A) The similarity of geographic markets;

(B) The relative size of each market, and the extent of the overall economic development in each market;

(C) The level of the market (e.g., wholesale, retail, etc.);

(D) The relevant market shares for the products, properties, or services transferred or provided;

(E) The location-specific costs of the factors of production and distribution;

(F) The extent of competition in each market with regard to the property or services under review;

(G) The economic condition of the particular industry, including whether the market is in contraction or expansion; and

(H) The alternatives realistically available to the buyer and seller.

(v) *Property or services.* Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangibles that are embedded in tangible property or services being transferred. The comparability of the embedded intangibles will be analyzed using the factors listed in § 1.482–4(c)(2)(iii)(B)(*1*) (Comparable intangible property). The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied. For guidance concerning the specific comparability considerations applicable to transfers of tangible and intangible property, see §§ 1.482–3 through 1.482–6; see also § 1.482–3(f), dealing with the coordination of the intangible and tangible property rules.

(4) *Special circumstances*—(i) *Market share strategy.* In certain circumstances, taxpayers may adopt strategies to enter new markets or to increase a product's share of an existing market (market share strategy). Such a strategy would be reflected by temporarily increased market development expenses or resale prices that are temporarily lower than the prices charged for comparable products in the same market. Whether or not the strategy is reflected in the transfer price depends on which party to the controlled transaction bears the costs of the pricing strategy. In any case, the effect of a market share strategy on a controlled transaction will be taken into account only if it can be shown that an uncontrolled taxpayer engaged in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following—

(A) The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;

(B) The market share strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

(C) The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented.

(ii) *Different geographic markets*—(A) *In general.* Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, but the extent of such differences may affect the reliability of the method for purposes of the best method rule. For this purpose, a geographic market is any geographic area in which the economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions.

(B) *Example.* The following example illustrates this paragraph (d)(4)(ii).

Example. Manuco, a wholly-owned foreign subsidiary of P, a U.S. corporation, manufactures products in Country Z for sale to P. No uncontrolled transactions are located that would provide a reliable measure of the arm's length result under the comparable uncontrolled price method. The district director considers applying the cost plus method or the comparable profits method. Information on uncontrolled taxpayers performing comparable functions under comparable

circumstances in the same geographic market is not available. Therefore, adjusted data from uncontrolled manufacturers in other markets may be considered in order to apply the cost plus method. In this case, comparable uncontrolled manufacturers are found in the United States. Accordingly, data from the comparable U.S. uncontrolled manufacturers, as adjusted to account for differences between the United States and Country Z's geographic market, is used to test the arm's length price paid by P to Manuco. However, the use of such data may affect the reliability of the results for purposes of the best method rule. See § 1.482–1(c).

(C) *Location savings.* If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.

(D) *Example.* The following example illustrates the principles of this paragraph (d)(4)(ii)(C).

Example. Couture, a U.S. apparel design corporation, contracts with Sewco, its wholly owned Country Y subsidiary, to manufacture its clothes. Costs of operating in Country Y are significantly lower than the operating costs in the United States. Although clothes with the Couture label sell for a premium price, the actual production of the clothes does not require significant specialized knowledge that could not be acquired by actual or potential competitors to Sewco at reasonable cost. Thus, Sewco's functions could be performed by several actual or potential competitors to Sewco in geographic markets that are similar to Country Y. Thus, the fact that production is less costly in Country Y will not, in and of itself, justify additional profits derived from lower operating costs in Country Y inuring to Sewco, because the competitive positions of the other actual or potential producers in similar geographic markets capable of performing the same functions at the same low costs indicate that at arm's length such profits would not be retained by Sewco.

(iii) *Transactions ordinarily not accepted as comparables*— (A) *In general.* Transactions ordinarily will not constitute reliable measures of an arm's length result for purposes of this section if—

(*1*) They are not made in the ordinary course of business; or

(*2*) One of the principal purposes of the uncontrolled transaction was to establish an arm's length result with respect to the controlled transaction.

(B) *Examples.* The following examples illustrate the principle of this paragraph (d)(4)(iii).

Example 1—Not in the ordinary course of business. USP, a United States manufacturer of computer software, sells its products to FSub, its foreign distributor in country X. Compco, a United States competitor of USP, also sells its products in X through unrelated distributors. However, in the year under review, Compco is forced into bankruptcy, and Compco liquidates its inventory by selling all of its products to unrelated distributors in X for a liquidation price. Because the sale of its entire inventory was not a sale in the ordinary course of business, Compco's sale cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

Example 2—Principal purpose of establishing an arm's length result. USP, a United States manufacturer of farm machinery, sells its products to FSub, its wholly-owned distributor in Country Y. USP, operating at nearly full capacity, sells 95% of its inventory to FSub. To make use of its excess capacity, and also to establish a comparable uncontrolled price for its transfer price to FSub, USP increases its production to full capacity. USP sells its excess inventory to Compco, an unrelated foreign distributor in Country X. Country X has approximately the same economic conditions as that of Country Y. Because one of the principal purposes of selling to Compco was to establish an arm's length price for its controlled transactions with FSub, USP's sale to Compco cannot be used as an uncontrolled comparable to determine USP's arm's length result from its controlled transaction.

(e) *Arm's length range*—(1) *In general.* In some cases, application of a pricing method will produce a single result that is the most reliable measure of an

arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).

(2) *Determination of arm's length range*—(i) *Single method.* The arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability. Use of more than one method may be appropriate for the purposes described in paragraph (c)(2)(iii) of this section (Best method rule).

(ii) *Selection of comparables.* Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. See § 1.482–1(d)(2) (Standard of comparability). The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

(iii) *Comparables included in arm's length range*—(A) *In general.* The arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions: the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference.

(B) *Adjustment of range to increase reliability.* If there are no uncontrolled comparables described in paragraph (e)(2)(iii)(A) of this section, the arm's length range is derived from the results of all the uncontrolled comparables, selected pursuant to paragraph (e)(2)(ii) of this section, that achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables so selected. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure.

(C) *Interquartile range.* For purposes of this section, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined analogously.

(3) *Adjustment if taxpayer's results are outside arm's length range.* If the results of a controlled transaction fall outside the arm's length range, the district director may make allocations that adjust the controlled taxpayer's result to any point within the arm's length range. If the interquartile range is used to determine the arm's length range, such adjustment will ordinarily be to the median of all the results. The median is the 50th percentile of the results, which is determined in a manner

analogous to that described in paragraph (e)(2)(iii)(C) of this section (Interquartile range). In other cases, an adjustment normally will be made to the arithmetic mean of all the results. See § 1.482–1(f)(2)(iii)(D) for determination of an adjustment when a controlled taxpayer's result for a multiple year period falls outside an arm's length range consisting of the average results of uncontrolled comparables over the same period.

(4) *Arm's length range not prerequisite to allocation.* The rules of this paragraph (e) do not require that the district director establish an arm's length range prior to making an allocation under section 482. Thus, for example, the district director may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method, as described in § 1.482–3(b), has been properly applied. However, if the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices in a manner consistent with the requirements set forth in § 1.482–1(e)(2)(iii), then no allocation will be made.

(5) *Examples.* The following examples illustrate the principles of this paragraph (e).

Example 1—Selection of comparables. (i) To evaluate the arm's length result of a controlled transaction between USSub, the United States taxpayer under review, and FP, its foreign parent, the district director considers applying the resale price method. The district director identifies ten potential uncontrolled transactions. The distributors in all ten uncontrolled transactions purchase and resell similar products and perform similar functions to those of USSub.

(ii) Data with respect to three of the uncontrolled transactions is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these three uncontrolled comparables is significantly lower than that of the other seven. Further, of those seven, adjustments for the identified material differences can be reliably made for only four of the uncontrolled transactions. Therefore, pursuant to § 1.482–1(e)(2)(ii) only these four uncontrolled comparables may be used to establish an arm's length range.

Example 2—Arm's length range consists of all the results. (i) The facts are the same as in *Example 1.* Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to § 1.482- 1(d)(2), the district director derives the following results:

Comparable	Result (price)
1	$44.00
2	45.00
3	45.00
4	45.50

(ii) The district director determines that data regarding the four uncontrolled transactions is sufficiently complete and accurate so that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, such differences have a definite and reasonably ascertainable effect, and appropriate adjustments were made for such differences. Accordingly, if the resale price method is determined to be the best method pursuant to § 1.482–1(c), the arm's length range for the controlled transaction will consist of the results of all of the uncontrolled comparables, pursuant to paragraph (e)(2)(iii)(A) of this section. Thus, the arm's length range in this case would be the range from $44 to $45.50.

Example 3—Arm's length range limited to interquartile range. (i) The facts are the same as in *Example 2,* except in this case there are some product and functional differences between the four uncontrolled comparables and USSub. However, the data is insufficiently complete to determine the effect of the differences. Applying the resale price method to the four uncontrolled comparables, and making adjustments to the uncontrolled comparables pursuant to § 1.482–1(d)(2), the district director derives the following results:

Uncontrolled comparable	Result (price)
1	$42.00
2	44.00
3	45.00
4	47.50

(ii) It cannot be established in this case that all material differences are likely to have been identified and reliable adjustments made for those differences. Accordingly, if the resale price method is determined to be the best method pursuant to § 1.482–1(c), the arm's length range for the controlled transaction must be established pursuant to paragraph (e)(2)(iii)(B) of this section. In this case, the district director uses the interquartile range to determine the arm's length range, which is the range from $43 to $46.25. If USSub's price falls outside this range, the district director may make an allocation. In this case that allocation

would be to the median of the results, or $44.50.

Example 4—Arm's length range limited to interquartile range. (i) To evaluate the arm's length result of controlled transactions between USP, a United States manufacturing company, and FSub, its foreign subsidiary, the district director considers applying the comparable profits method. The district director identifies 50 uncontrolled taxpayers within the same industry that potentially could be used to apply the method.

(ii) Further review indicates that only 20 of the uncontrolled manufacturers engage in activities requiring similar capital investments and technical know-how. Data with respect to five of the uncontrolled manufacturers is very limited, and although some material differences can be identified and adjusted for, the level of comparability of these five uncontrolled comparables is significantly lower than that of the other 15. In addition, for those five uncontrolled comparables it is not possible to accurately allocate costs between the business activity associated with the relevant transactions and other business activities. Therefore, pursuant to § 1.482–1(e)(2)(ii) only the other fifteen uncontrolled comparables may be used to establish an arm's length range.

(iii) Although the data for the fifteen remaining uncontrolled comparables is relatively complete and accurate, there is a significant possibility that some material differences may remain. The district director has determined, for example, that it is likely that there are material differences in the level of technical expertise or in management efficiency. Accordingly, if the comparable profits method is determined to be the best method pursuant to § 1.482–1(c), the arm's length range for the controlled transaction may be established only pursuant to paragraph (e)(2)(iii)(B) of this section.

(f) *Scope of review*—(1) *In general.* The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm's length with an uncontrolled taxpayer.

(i) *Intent to evade or avoid tax not a prerequisite.* In making allocations under section 482, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances.

(ii) *Realization of income not a prerequisite*—(A) *In general.* The district director may make an allocation under section 482 even if the income ultimately anticipated from a series of transactions has not been or is never realized. For example, if a controlled taxpayer sells a product at less than an arm's length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first year. Similarly, if a controlled taxpayer lends money to a related taxpayer in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second controlled taxpayer does not realize income during such year. Finally, even if two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction, an allocation under section 482 is not precluded.

(B) *Example.* The following example illustrates this paragraph (f)(1)(ii).

Example. USSub is a U.S. subsidiary of FP, a foreign corporation. Parent manufactures product X and sells it to USSub. USSub functions as a distributor of product X to unrelated customers in the United States. The fact that FP may incur a loss on the manufacture and sale of product X does not by itself establish that USSub, dealing with FP at arm's length, also would incur a loss. An independent distributor acting at arm's length with its supplier would in many circumstances be expected to earn a profit without regard to the level of profit earned by the supplier.

(iii) *Nonrecognition provisions may not bar allocation*—(A) *In general.* If necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for nonrecognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031).

(B) *Example.* The following example illustrates this paragraph (f)(1)(iii).

Example. (i) In Year 1 USP, a United States corporation, bought 100 shares of UR, an unrelated corporation, for $100,000. In Year 2, when the value of the UR stock had decreased to $40,000, USP contributed all 100 shares of UR stock to its wholly-owned subsidiary in exchange for subsidiary's capital stock. In Year 3, the subsidiary sold all of the UR stock for $40,000 to an unrelated buyer, and on its U.S. income tax return, claimed a loss of $60,000 attributable to the sale of the UR stock. USP and its subsidiary do not file a consolidated return.

(ii) In determining the true taxable income of the subsidiary, the district director may disallow the loss of $60,000 on the ground that the loss was incurred by USP. *National Securities Corp. v Commissioner,* 137 F.2d 600 (3rd Cir. 1943), cert. denied, 320 U.S. 794 (1943).

(iv) *Consolidated returns.* Section 482 and the regulations thereunder apply to all controlled taxpayers, whether the controlled taxpayer files a separate or consolidated U.S. income tax return. If a controlled taxpayer files a separate return, its true separate taxable income will be determined. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer must be determined consistently with the principles of a consolidated return.

(2) *Rules relating to determination of true taxable income.* The following rules must be taken into account in determining the true taxable income of a controlled taxpayer.

(i) *Aggregation of transactions*—(A) *In general.* The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services, as defined in § 1.6038A–3(c)(7)(vii).

(B) *Examples.* The following examples illustrate this paragraph (f)(2)(i).

Example 1. P enters into a license agreement with S1, its subsidiary, that permits S1 to use a proprietary manufacturing process and to sell the output from this process throughout a specified region. S1 uses the manufacturing process and sells its output to S2, another subsidiary of P, which in turn resells the output to uncontrolled parties in the specified region. In evaluating the arm's length character of the royalty paid by S1 to P, it may be appropriate to consider the arm's length character of the transfer prices charged by S1 to S2 and the aggregate profits earned by S1 and S2 from the use of the manufacturing process and the sale to uncontrolled parties of the products produced by S1.

Example 2. S1, S2, and S3 are Country Z subsidiaries of U.S. manufacturer P. S1 is the exclusive Country Z distributor of computers manufactured by P. S2 provides marketing services in connection with sales of P computers in Country Z, and in this regard uses significant marketing intangibles provided by P. S3 administers the warranty program with respect to P computers in Country Z, including maintenance and repair services. In evaluating the arm's length character of the transfer price paid by S1 to P, of the fees paid by S2 to P for the use of P marketing intangibles, and of the service fees earned by S2 and S3, it may be appropriate to consider the combined effects of these separate transactions because they are so interrelated that they are most reliably analyzed on an aggregated basis.

Example 3. The facts are the same as in *Example 2.* In addition, U1, U2, and U3 are uncontrolled taxpayers that carry out functions comparable to those of S1, S2, and S3, respectively, with respect to computers produced by unrelated manufacturers. R1, R2, and R3 are a controlled group of taxpayers (unrelated to the P controlled group) that also carry out functions comparable to those of S1, S2, and S3 with respect to computers produced by their common parent. Prices charged to uncontrolled customers of the R group differ from the prices charged to customers of U1, U2, and U3. In determining whether the transactions of U1, U2, and U3, or the transactions of R1, R2, and R3 would provide a more reliable measure of the arm's length result, it is determined that the interrelated R group transactions are more reliable than the wholly independent transactions of U1, U2, and U3, given the interrelationship of the P group transactions.

Example 4. P enters into a license agreement with S1 that permits S1 to use a propriety process for manufacturing product X and to sell product X to uncontrolled parties throughout a specified region. P also sells to S1 product Y which is manufactured by P in the United States, and which is unrelated to product X. Product Y is resold by S1 to uncontrolled parties in the specified region. In evaluating the arm's length character of the royalty paid by S1 to P for the use of the manufacturing process for product X, and

the transfer prices charged for unrelated product Y, it would not be appropriate to consider the combined effects of these separate and unrelated transactions.

(ii) *Allocation based on taxpayer's actual transactions*—(A) *In general.* The district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance. However, the district director may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. In such cases the district director may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer. See § 1.482–1(d)(3) (Factors for determining comparability, Contractual terms and Risk); §§ 1.482–3(e) and 1.482–4(d) (Unspecified methods).

(B) *Example.* The following example illustrates this paragraph (f)(2)(ii).

Example. P and S are controlled taxpayers. P enters into a license agreement with S that permits S to use a proprietary process for manufacturing product X. Using its sales and marketing employees, S sells product X to related and unrelated customers outside the United States. If the license agreement between P and S has economic substance, the district director ordinarily will not restructure the taxpayer's transaction to treat P as if it had elected to exploit directly the manufacturing process. However, the fact that P could have manufactured product X may be taken into account under § 1.482–4(d) in determining the arm's length consideration for the controlled transaction. For an example of such an analysis, see *Example* in § 1.482–4(d)(2).

(iii) *Multiple year data*—(A) *In general.* The results of a controlled transaction ordinarily will be compared with the results of uncontrolled comparables occurring in the taxable year under review. It may be appropriate, however, to consider data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review. If data relating to uncontrolled comparables from multiple years is used, data relating to the controlled taxpayer for the same years ordinarily must be considered. However, if such data is not available, reliable data from other years, as adjusted under paragraph (d)(2) (Standard of comparability) of this section may be used.

(B) *Circumstances warranting consideration of multiple year data.* The extent to which it is appropriate to consider multiple-year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data is available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible being examined. Data from one or more years before or after the taxable year under review must ordinarily be considered for purposes of applying the provisions of § 1.482–1(d)(3)(iii) (Risk), § 1.482–1(d)(4)(i) (Market share strategy), § 1.482–4(f)(2) (Periodic adjustments), and § 1.482–5 (Comparable profits method). On the other hand, multiple-year data ordinarily will not be considered for purposes of applying the comparable uncontrolled price method (except to the extent that risk or market share strategy issues are present).

(C) *Comparable effect over comparable period.* Data from multiple years may be considered to determine whether the same economic conditions that caused the controlled taxpayer's results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm's length range. For example, given that uncontrolled taxpayers enter into transactions with the ultimate expectation of earning a profit, persistent losses among controlled taxpayers may be an indication of non-arm's length dealings. Thus, if a controlled taxpayer that realizes a loss with respect to a controlled transaction seeks to demonstrate that the loss is within the arm's length range, the district director may take into account data from taxable years other than the taxable

year of the transaction to determine whether the loss was attributable to arm's length dealings. The rule of this paragraph (f)(2)(iii)(C) is illustrated by *Example 3* of paragraph (f)(2)(iii)(E) of this section.

(D) *Applications of methods using multiple year averages.* If a comparison of a controlled taxpayer's average result over a multiple year period with the average results of uncontrolled comparables over the same period would reduce the effect of short-term variations that may be unrelated to transfer pricing, it may be appropriate to establish a range derived from the average results of uncontrolled comparables over a multiple year period to determine if an adjustment should be made. In such a case the district director may make an adjustment if the controlled taxpayer's average result for the multiple year period is not within such range. Such a range must be determined in accordance with § 1.482–1(e) (Arm's length range). An adjustment in such a case ordinarily will be equal to the difference, if any, between the controlled taxpayer's result for the taxable year and the mid-point of the uncontrolled comparables' results for that year. If the interquartile range is used to determine the range of average results for the multiple year period, such adjustment will ordinarily be made to the median of all the results of the uncontrolled comparables for the taxable year. See *Example 2* of § 1.482–5(e). In other cases, the adjustment normally will be made to the arithmetic mean of all the results of the uncontrolled comparables for the taxable year. However, an adjustment will be made only to the extent that it would move the controlled taxpayer's multiple year average closer to the arm's length range for the multiple year period or to any point within such range. In determining a controlled taxpayer's average result for a multiple year period, adjustments made under this section for prior years will be taken into account only if such adjustments have been finally determined, as described in § 1.482–1(g)(2)(iii). See *Example 3* of § 1.482–5(e).

(E) *Examples.* The following examples, in which S and P are controlled taxpayers, illustrate this paragraph (f)(2)(iii). *Examples 1* and *4* also illustrate the principle of the arm's length range of paragraph (e) of this section.

Example 1. P sold product Z to S for $60 per unit in 1995. Applying the resale price method to data from uncontrolled comparables for the same year establishes an arm's length range of prices for the controlled transaction from $52 to $59 per unit. Since the price charged in the controlled transaction falls outside the range, the district director would ordinarily make an allocation under section 482. However, in this case there are cyclical factors that affect the results of the uncontrolled comparables (and that of the controlled transaction) that cannot be adequately accounted for by specific adjustments to the data for 1995. Therefore, the district director considers results over multiple years to account for these factors. Under these circumstances, it is appropriate to average the results of the uncontrolled comparables over the years 1993, 1994, and 1995 to determine an arm's length range. The averaged results establish an arm's length range of $56 to $58 per unit. For consistency, the results of the controlled taxpayers must also be averaged over the same years. The average price in the controlled transaction over the three years is $57. Because the controlled transfer price of product Z falls within the arm's length range, the district director makes no allocation.

Example 2. (i) FP, a Country X corporation, designs and manufactures machinery in Country X. FP's costs are incurred in Country X currency. USSub is the exclusive distributor of FP's machinery in the United States. The price of the machinery sold by FP to USSub is expressed in Country X currency. Thus, USSub bears all of the currency risk associated with fluctuations in the exchange rate between the time the contract is signed and the payment is made. The prices charged by FP to USSub for 1995 are under examination. In that year, the value of the dollar depreciated against the currency of Country X, and as a result, USSub's gross margin was only 8%.

(ii) UD is an uncontrolled distributor of similar machinery that performs distribution functions substantially the same as those performed by USSub, except that UD purchases and resells machinery in transactions where both the purchase and resale prices are denominated in U.S. dollars. Thus, UD had no currency exchange risk. UD's gross margin in 1995 was 10%. UD's average gross margin for the period 1990 to 1998 has been 12%.

(iii) In determining whether the price charged by FP to USSub in 1995 was arm's length, the district director may consider USSub's average gross margin for an appropriate period before and after 1995 to determine whether USSub's average gross margin