

be the basis for a separate allocation. However, if the employee continues to render services to the related entity by supervising the manufacturing operation after the secret process has been effectively integrated into such operation, a separate allocation with respect to such additional services may be made in accordance with the rules of this paragraph.

(c) *Use of tangible property*—(1) *General rule.* Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in paragraph (c)(2)(i) of this section) the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) *Arm's length charge*—(i) *In general.* For purposes of paragraph (c) of this section, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

(ii) *Safe haven rental charge.* See §1.482-2(c)(2)(ii) (26 CFR Part 1 revised as of April 1, 1985), for the determination of safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(iii) *Subleases*—(A) Except as provided in paragraph (c)(2)(iii)(B) of this section, where possession, use, or occu-

pancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period. Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(B) The provisions of paragraph (c)(2)(iii)(A) of this section shall not apply if either—

(1) The taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (c)(2)(i) of this section; or

(2) During the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the same general type as the property in question to unrelated persons.

(d) *Transfer of property.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving the transfer of property, see §§1.482-3 through 1.482-6.

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§ 1.482-3 Methods to determine taxable income in connection with a transfer of tangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of tangible property must be determined under one of the six methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of §1.482-1, including the best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), and the arm's length range of §1.482-1(e). The methods are—

(1) The comparable uncontrolled price method, described in paragraph (b) of this section;

(2) The resale price method, described in paragraph (c) of this section;

(3) The cost plus method, described in paragraph (d) of this section;

(4) The comparable profits method, described in § 1.482-5;

(5) The profit split method, described in § 1.482-6; and

(6) Unspecified methods, described in paragraph (e) of this section.

(b) *Comparable uncontrolled price method*—(1) *In general.* The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

(2) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in § 1.482-1(c). The application of these factors under the comparable uncontrolled price method is discussed in paragraph (b)(2)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of § 1.482-1(d). Although all of the factors described in § 1.482-1(d)(3) must be considered, similarity of products generally will have the greatest effect on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on

price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material product differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(B) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of § 1.482-1(d)(2). Specific examples of the factors that may be particularly relevant to this method include—

- (1) Quality of the product;
- (2) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);
- (3) Level of the market (i.e., wholesale, retail, etc.);
- (4) Geographic market in which the transaction takes place;
- (5) Date of the transaction;
- (6) Intangible property associated with the sale;
- (7) Foreign currency risks; and
- (8) Alternatives realistically available to the buyer and seller.

(iii) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482-1(c) (Best method rule).

(3) *Arm's length range.* See § 1.482-1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The principles of this paragraph (b) are illustrated by the following examples.

Example 1. Comparable Sales of Same Product. USM, a U.S. manufacturer, sells the same product to both controlled and uncontrolled distributors. The circumstances surrounding the controlled and uncontrolled

transactions are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. USM's factory. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments are made to the results of the uncontrolled transaction to account for such differences. No other material difference has been identified between the controlled and uncontrolled transactions. Because USM sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result. See § 1.482-3(b)(2)(ii)(A).

Example 2. Effect of Trademark. The facts are the same as in *Example 1*, except that USM affixes its valuable trademark to the property sold in the controlled transactions, but does not affix its trademark to the property sold in the uncontrolled transactions. Under the facts of this case, the effect on price of the trademark is material and cannot be reliably estimated. Because there are material product differences for which reliable adjustments cannot be made, the comparable uncontrolled price method is unlikely to provide a reliable measure of the arm's length result. See § 1.482-3(b)(2)(ii)(A).

Example 3. Minor Product Differences. The facts are the same as in *Example 1*, except that USM, which manufactures business machines, makes minor modifications to the physical properties of the machines to satisfy specific requirements of a customer in controlled sales, but does not make these modifications in uncontrolled sales. If the minor physical differences in the product have a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of § 1.482-1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

Example 4. Effect of Geographic Differences. FM, a foreign specialty radio manufacturer, sells its radios to a controlled U.S. distributor, AM, that serves the West Coast of the United States. FM sells its radios to uncontrolled distributors to serve other regions in the United States. The product in the controlled and uncontrolled transactions is the same, and all other circumstances surrounding the controlled and uncontrolled transactions are substantially the same,

other than the geographic differences. If the geographic differences are unlikely to have a material effect on price, or they have definite and reasonably ascertainable effects for which adjustments are made, then the adjusted results of the uncontrolled sales may be used under the comparable uncontrolled price method to establish an arm's length range pursuant to § 1.482-1(e)(2)(iii)(A). If the effects of the geographic differences would be material but cannot be reliably ascertained, then the reliability of the results will be diminished. However, the comparable uncontrolled price method may still provide the most reliable measure of an arm's length result, pursuant to the best method rule of § 1.482-1(c), and, if so, an arm's length range may be established pursuant to § 1.482-1(e)(2)(iii)(B).

(5) *Indirect evidence of comparable uncontrolled transactions—(i) In general.* A comparable uncontrolled price may be derived from data from public exchanges or quotation media, but only if the following requirements are met—

(A) The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;

(B) The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used by uncontrolled taxpayers in the industry; and

(C) The amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by uncontrolled taxpayers.

(ii) *Limitation.* Use of data from public exchanges or quotation media may not be appropriate under extraordinary market conditions.

(iii) *Examples.* The following examples illustrate this paragraph (b)(5).

Example 1. Use of Quotation Medium. (i) On June 1, USOil, a United States corporation, enters into a contract to purchase crude oil from its foreign subsidiary, FS, in Country Z. USOil and FS agree to base their sales price on the average of the prices published for that crude in a quotation medium in the five days before August 1, the date set for delivery. USOil and FS agree to adjust the price for the particular circumstances of their transactions, including the quantity of the crude sold, contractual terms, transportation costs, risks borne, and other factors that affect the price.

(ii) The quotation medium used by USOil and FS is widely and routinely used in the ordinary course of business in the industry to establish prices for uncontrolled sales. Because USOil and FS use the data to set their sales price in the same way that unrelated parties use the data from the quotation medium to set their sales prices, and appropriate adjustments were made to account for differences, the price derived from the quotation medium used by USOil and FS to set their transfer prices will be considered evidence of a comparable uncontrolled price.

Example 2. Extraordinary Market Conditions. The facts are the same as in *Example 1*, except that before USOil and FS enter into their contract, war breaks out in Countries X and Y, major oil producing countries, causing significant instability in world petroleum markets. As a result, given the significant instability in the price of oil, the prices listed on the quotation medium may not reflect a reliable measure of an arm's length result. See § 1.482-3(b)(5)(ii).

(c) *Resale price method*—(1) *In general.* The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale. For this purpose, packaging, repackaging, labeling, or minor assembly do not ordinarily constitute physical alteration. Further the resale price method is not ordinarily used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods.

(2) *Determination of arm's length price*—(i) *In general.* The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review.

(ii) *Applicable resale price.* The applicable resale price is equal to either the resale price of the particular item of property involved or the price at which contemporaneous resales of the same property are made. If the property purchased in the controlled sale is resold to one or more related parties in a se-

ries of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the property is resold to an uncontrolled party, or the price at which contemporaneous resales of the same property are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the group participating in the series of controlled sales and final uncontrolled resales, as well as any other relevant factors described in § 1.482-1(d)(3).

(iii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions.

(iv) *Arm's length range.* See § 1.482-1(e)(2) for determination of the arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general.* Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in § 1.482-1(c). The application of these factors under the resale price method is discussed in paragraphs (c)(3) (ii) and (iii) of this section.

(ii) *Comparability*—(A) *Functional comparability.* The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of § 1.482-1(d). A reseller's gross profit provides compensation for the performance of resale functions related to the product or products under review, including an operating profit in return for the reseller's investment of capital and the assumption of risks. Therefore, although all of the factors described in § 1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale,

because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. For example, distributors of a wide variety of consumer durables might perform comparable distribution functions without regard to the specific durable goods distributed. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve the distribution of products of the same general type (e.g., consumer electronics). Furthermore, significant differences in the value of the distributed goods due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit margin, adjustments should be made to the gross profit margin earned with respect to the uncon-

trolled transaction according to the comparability provisions of §1.482-1(d)(2). For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

(1) Inventory levels and turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;

(2) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(3) Sales, marketing, advertising programs and services, (including promotional programs, rebates, and co-op advertising);

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

(5) Foreign currency risks.

(D) *Sales agent.* If the controlled taxpayer is comparable to a sales agent that does not take title to goods or otherwise assume risks with respect to ownership of such goods, the commission earned by such sales agent, expressed as a percentage of the uncontrolled sales price of the goods involved, may be used as the comparable gross profit margin.

(iii) *Data and assumptions—(A) In general.* The reliability of the results derived from the resale price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482-1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit margin affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit margin,

the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the uncontrolled comparable should be consistent in the reporting of items (such as discounts, returns and allowances, rebates, transportation costs, insurance, and packaging) between cost of goods sold and operating expenses.

(4) *Examples.* The following examples illustrate the principles of this paragraph (c).

Example 1. A controlled taxpayer sells property to another member of its controlled group that resells the property in uncontrolled sales. There are no changes in the beginning and ending inventory for the year under review. Information regarding an uncontrolled comparable is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the applicable resale price of the property involved in the controlled sale is \$100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale is a price of \$80 (\$100 minus (20%×\$100)).

Example 2. (i) S, a U.S. corporation, is the exclusive distributor for FP, its foreign parent. There are no changes in the beginning and ending inventory for the year under review. S's total reported cost of goods sold is \$800, consisting of \$600 for property purchased from FP and \$200 of other costs of goods sold incurred to unrelated parties. S's applicable resale price and reported gross profit are as follows:

Applicable resale price	\$1000
Cost of goods sold:	
Cost of purchases from FP	600
Costs incurred to unrelated parties	200
Reported gross profit	200

(ii) The district director determines that the appropriate gross profit margin is 25%. Therefore, S's appropriate gross profit is \$250 (i.e., 25% of the applicable resale price of \$1000). Because S is incurring costs of sales to unrelated parties, an arm's length price for property purchased from FP must be determined under a two-step process. First, the appropriate gross profit (\$250) is subtracted from the applicable resale price (\$1000). The resulting amount (\$750) is then reduced by the costs of sales incurred to unrelated parties (\$200). Therefore, an arm's length price for S's cost of sales of FP's product in this case equals \$550 (i.e., \$750 minus \$200).

Example 3. FP, a foreign manufacturer, sells Product to USSub, its U.S. subsidiary, which in turn sells Product to its domestic affiliate Sister. Sister sells Product to unrelated buyers. In this case, the applicable re-

sale price is the price at which Sister sells Product in uncontrolled transactions. The determination of the appropriate gross profit margin for the sale from FP to USSub will take into account the functions performed by USSub and Sister, as well as other relevant factors described in §1.482-1(d)(3).

Example 4. USSub, a U.S. corporation, is the exclusive distributor of widgets for its foreign parent. To determine whether the gross profit margin of 25% earned by USSub is an arm's length result, the district director considers applying the resale price method. There are several uncontrolled distributors that perform similar functions under similar circumstances in uncontrolled transactions. However, the uncontrolled distributors treat certain costs such as discounts and insurance as cost of goods sold, while USSub treats such costs as operating expenses. In such cases, accounting reclassifications, pursuant to §1.482-3(c)(3)(iii)(B), must be made to ensure consistent treatment of such material items. Inability to make such accounting reclassifications will decrease the reliability of the results of the uncontrolled transactions.

Example 5. (i) USP, a U.S. corporation, manufactures Product X, an unbranded widget, and sells it to FSub, its wholly owned foreign subsidiary. FSub acts as a distributor of Product X in country M, and sells it to uncontrolled parties in that country. Uncontrolled distributors A, B, C, D, and E distribute competing products of approximately similar value in country M. All such products are unbranded.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled distributors and the contractual terms under which they operate in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled distributors and FSub. Because the available data is sufficiently complete and accurate to conclude 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 reliable adjustments are made to account for such differences, the results of each of the uncontrolled distributors may be used to establish an arm's length range pursuant to §1.482-1(e)(2)(iii)(A).

Example 6. The facts are the same as *Example 5*, except that sufficient data is not available to determine whether any of the uncontrolled distributors provide warranties or to determine the payment terms of the contracts. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether

these differences exist between the controlled and uncontrolled transactions diminishes the reliability of the results of the uncontrolled comparables. However, the reliability of the results may be enhanced by the application of a statistical method when establishing an arm's length range pursuant to §1.482-1(e)(2)(iii)(B).

Example 7. The facts are the same as in *Example 5*, except that Product X is branded with a valuable trademark that is owned by P. A, B, and C distribute unbranded competing products, while D and E distribute products branded with other trademarks. D and E do not own any rights in the trademarks under which their products are sold. The value of the products that A, B, and C sold are not similar to the value of the products sold by S. The value of products sold by D and E, however, is similar to that of Product X. Although close product similarity is not as important for a reliable application of the resale price method as for the comparable uncontrolled price method, significant differences in the value of the products involved in the controlled and uncontrolled transactions may affect the reliability of the results. In addition, because in this case it is difficult to determine the effect the trademark will have on price or profits, reliable adjustments for the differences cannot be made. Because D and E have a higher level of comparability than A, B, and C with respect to S, pursuant to §1.482-1(e)(2)(ii), only D and E may be included in an arm's length range.

(d) *Cost plus method—(1) In general.* The cost plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The cost plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.

(2) *Determination of arm's length price—(i) In general.* The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction.

(ii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.

(iii) *Arm's length range.* See §1.482-1(e)(2) for determination of an arm's length range.

(3) *Comparability and reliability considerations—(i) In general.* Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482-1(c).

(ii) *Comparability—(A) Functional comparability.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of §1.482-1(d). A producer's gross profit provides compensation for the performance of the production functions related to the product or products under review, including an operating profit for the producer's investment of capital and assumption of risks. Therefore, although all of the factors described in §1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers. In the absence of such sales, an appropriate gross profit markup may be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group.

(B) *Other comparability factors.* Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions involve the production of goods within the same product categories. Furthermore, significant differences in the value of the

products due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the comparable uncontrolled transaction according to the provisions of § 1.482-1(d)(2). For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include—

- (1) The complexity of manufacturing or assembly;
- (2) Manufacturing, production, and process engineering;
- (3) Procurement, purchasing, and inventory control activities;
- (4) Testing functions;
- (5) Selling, general, and administrative expenses;
- (6) Foreign currency risks; and
- (7) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms).

(D) *Purchasing agent.* If a controlled taxpayer is comparable to a purchasing agent that does not take title to property or otherwise assume risks with respect to ownership of such goods, the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may be used as the appropriate gross profit markup.

(iii) *Data and assumptions—(A) In general.* The reliability of the results derived from the cost plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See § 1.482-1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit markup affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the comparable uncontrolled transaction should be consistent in the reporting of costs between cost of goods sold and operating expenses. The term *cost of producing* includes the cost of acquiring property that is held for resale.

(4) *Examples.* The following examples illustrate the principles of this paragraph (d).

Example 1. (i) USP, a domestic manufacturer of computer components, sells its products to FS, its foreign distributor. UT1, UT2, and UT3 are domestic computer component manufacturers that sell to uncontrolled foreign purchasers.

(ii) Relatively complete data is available regarding the functions performed and risks borne by UT1, UT2, and UT3, and the contractual terms in the uncontrolled transactions. In addition, data is available to ensure accounting consistency between all of the uncontrolled manufacturers and USP. Because the available data is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified, the effect of the differences are definite and reasonably ascertainable,

and reliable adjustments are made to account for the differences, an arm's length range can be established pursuant to § 1.482-1(e)(2)(iii)(A).

Example 2. The facts are the same as in *Example 1*, except that USP accounts for supervisory, general, and administrative costs as operating expenses, which are not allocated to its sales to FS. The gross profit markups of UT1, UT2, and UT3, however, reflect supervisory, general, and administrative expenses because they are accounted for as costs of goods sold. Accordingly, the gross profit markups of UT1, UT2, and UT3 must be adjusted as provided in paragraph (d)(3)(iii)(B) of this section to provide accounting consistency. If data is not sufficient to determine whether such accounting differences exist between the controlled and uncontrolled transactions, the reliability of the results will be decreased.

Example 3. The facts are the same as in *Example 1*, except that under its contract with FS, USP uses materials consigned by FS. UT1, UT2, and UT3, on the other hand, purchase their own materials, and their gross profit markups are determined by including the costs of materials. The fact that USP does not carry an inventory risk by purchasing its own materials while the uncontrolled producers carry inventory is a significant difference that may require an adjustment if the difference has a material effect on the gross profit markups of the uncontrolled producers. Inability to reasonably ascertain the effect of the difference on the gross profit markups will affect the reliability of the results of UT1, UT2, and UT3.

Example 4. (i) FS, a foreign corporation, produces apparel for USP, its U.S. parent corporation. FS purchases its materials from unrelated suppliers and produces the apparel according to designs provided by USP. The district director identifies 10 uncontrolled foreign apparel producers that operate in the same geographic market and are similar in many respect to FS.

(ii) Relatively complete data is available regarding the functions performed and risks borne by the uncontrolled producers. In addition, data is sufficiently detailed to permit adjustments for differences in accounting practices. However, sufficient data is not available to determine whether it is likely that all material differences in contractual terms have been identified. For example, it is not possible to determine which parties in the uncontrolled transactions bear currency risks. Because differences in these contractual terms could materially affect price or profits, the inability to determine whether differences exist between the controlled and uncontrolled transactions will diminish the reliability of these results. Therefore, the reliability of the results of the uncontrolled transactions must be enhanced by the application of a statistical method in establishing

an arm's length range pursuant to § 1.482-1(e)(2)(iii)(B).

(e) *Unspecified methods*—(1) *In general.* Methods not specified in paragraphs (a)(1), (2), (3), (4), and (5) of this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length. Any method used under this paragraph (e) must be applied in accordance with the provisions of § 1.482-1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See § 1.482-1(c). Therefore, in accordance with § 1.482-1(d) (Comparability), to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(2) *Example.* The following example illustrates an application of the principle of this paragraph (e).

Example. Amcan, a U.S. company, produces unique vessels for storing and transporting toxic waste, toxicans, at its U.S. production facility. Amcan agrees by contract to supply its Canadian subsidiary, Cancan, with 4000 toxicans per year to serve the Canadian market for toxicans. Prior to entering into the

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contract with Cancan, Amcan had received a bona fide offer from an independent Canadian waste disposal company, Cando, to serve as the Canadian distributor for toxicans and to purchase a similar number of toxicans at a price of \$5,000 each. If the circumstances and terms of the Cancan supply contract are sufficiently similar to those of the Cando offer, or sufficiently reliable adjustments can be made for differences between them, then the Cando offer price of \$5,000 may provide reliable information indicating that an arm's length consideration under the Cancan contract will not be less than \$5,000 per toxican.

(f) *Coordination with intangible property rules.* The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property (embedded intangible). Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. Pursuant to § 1.482-1(d)(3)(v), however, the embedded intangible must be accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. For example, because product comparability has the greatest effect on an application of the comparable uncontrolled price method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method. The effect of embedded intangibles on comparability will be determined under the principles of § 1.482-4. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property), it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property under § 1.482-4. For example, if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the ma-

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chine, then the arm's length consideration for the transfer of that right must be determined separately under § 1.482-4.

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§ 1.482-4 Methods to determine taxable income in connection with a transfer of intangible property.

(a) *In general.* The arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four methods listed in this paragraph (a). Each of the methods must be applied in accordance with all of the provisions of § 1.482-1, including the best method rule of § 1.482-1(c), the comparability analysis of § 1.482-1(d), and the arm's length range of § 1.482-1(e). 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. See § 1.482-4(f)(2) (Periodic adjustments). The available methods are—

- (1) The comparable uncontrolled transaction method, described in paragraph (c) of this section;
- (2) The comparable profits method, described in § 1.482-5;
- (3) The profit split method, described in § 1.482-6; and
- (4) Unspecified methods described in paragraph (d) of this section.

(b) *Definition of intangible.* For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual—

- (1) Patents, inventions, formulae, processes, designs, patterns, or know-how;
- (2) Copyrights and literary, musical, or artistic compositions;
- (3) Trademarks, trade names, or brand names;
- (4) Franchises, licenses, or contracts;
- (5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- (6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph