

**Office of Chief Counsel
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Memorandum**

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subject: Comparability Adjustments under § 482

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Year1 =
Year2 =
Brand1 =
Brand2 =
Brand3 =
Territory =
Law Firm =
Products =

ISSUE

Whether a comparability adjustment must be made under Treas. Reg. §§1.482-1 and 1.482-4 for differences in sales volume between Taxpayer's controlled transfers of trademarks and service marks and certain uncontrolled transactions?

CONCLUSION

Under Treas. Reg. §§1.482-1 and 1.482-4, comparability adjustments for sales volume must be made only if the differences between the controlled and uncontrolled transactions would materially affect the measure of the arm's length result under the transfer pricing method being applied and the adjustments would improve the reliability of results.

FACTS

Taxpayer is a manufacturer of Products. It owns the rights to several trademarks and service marks, including the brand names Brand1, Brand2, and Brand3. Taxpayer and its controlled foreign corporations ("CFCs") manufacture, distribute and market Products throughout Territory. Taxpayer licenses the right to use, and in certain cases sub-license, its trademarks and service marks to certain of its CFCs in exchange for royalties calculated as a percentage of the CFCs' net sales.

To determine whether the royalties paid by the CFCs to Taxpayer during its Year1 and Year2 taxable years were arm's length, Taxpayer engaged Law Firm to prepare transfer pricing reports (the "Studies") for each year. In each of the Studies, Law Firm selected 25 licensing agreements between Taxpayer and uncontrolled parties as comparable uncontrolled transactions ("CUTs"). Law Firm concluded that, generally, all of these uncontrolled licensing agreements were sufficiently comparable to the controlled licensing transactions to provide a reliable measure of an arm's length result under the CUT method described in Treas. Reg. §1.482-4(c). Most of the CUTs selected by Taxpayer require the uncontrolled licensee to pay a royalty calculated as a fixed percentage of the licensee's net sales regardless of its sales volume. However, a small subset of these CUTs contain provisions that reduce the royalty rate as sales volume increases ("sales volume adjustment provisions"). Based on the presence of these provisions in this subset of selected CUTs, Law Firm concluded in the Studies that "[r]oyalties fall quite sharply as licensee volume increases" and that sales volume should therefore be taken into account in determining an arm's length range of royalty rates.¹

¹ We understand that actual sales data for Year1 and Year2 was available for some, but not, all of the CUTs that did not include sales volume adjustment provisions. The actual Year1 and Year2 sales volumes for the uncontrolled licensees in these CUTs were generally substantially lower than the sales volumes of each of the controlled licensees during these years.

To determine an arm's length range of royalty rates, Law Firm first determined an unadjusted interquartile range ("IQR") of royalty rates based on the royalty rates paid by the uncontrolled licensees under each of the selected CUTs. The CUTs used to derive the unadjusted IQR included both the subset of agreements that contain sales volume adjustment provisions and the other agreements that do not contain such provisions. Law Firm then adjusted this IQR downward by applying a "volume curve," which was apparently derived from the sales volume adjustment provisions of two of the CUTs.² Based on the adjusted IQR, Law Firm concluded that the royalties paid by the CFCs to Taxpayer during Year1 and Year2 were arm's length. You have asked whether Taxpayer's sales volume comparability adjustment is either required or prohibited under the section 482 transfer pricing regulations.

LAW

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). Treas. Reg. §1.482-1(b)(1). Because identical transactions between uncontrolled taxpayers can rarely be located, 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. Id. 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 Treas. Reg. §1.482-1(c).

The best method rule requires that the arm's length result of a controlled transaction be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Treas. Reg. §1.482-1(c)(1). 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 be taken 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. Treas. Reg. §1.482-1(c)(2).

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"), including functions, contractual terms, risks, economic conditions, and property or services. Treas. Reg. §1.482-1(d)(1). While a specific comparability factor

² In addition to these two CUTs, at least one other selected CUT apparently had a sales volume adjustment provision but it was apparently not taken into account in determining Taxpayer's sales volume adjustment. Law Firm also made a comparability adjustment for differences in the advertising and promotion requirements among the controlled and uncontrolled licensees. This memorandum does not address the appropriateness of that adjustment.

may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Id.

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. Treas. Reg. §1.482-1(d)(3)(ii)(A). Sales or purchase volume is a contractual term that must be compared in determining the degree of comparability between the controlled and uncontrolled transactions. Treas. Reg. §1.482-1(d)(3)(ii)(A)(2).

Taxpayer has applied the comparable uncontrolled transaction (“CUT”) method to the controlled transfers of intangible property in question.³ When applying the CUT method to evaluate transfers of intangible property, the degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of Treas. Reg. §1.482-1(d). Treas. Reg. §1.482-4(c)(2). Although all of the factors described in Treas. Reg. §1.482-1(d)(3) must be considered, specific factors may be particularly relevant to this method. Treas. Reg. §1.482-4(c)(2)(iii)(A). In particular, the application of this method requires that the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property. Id. In addition, because differences in contractual terms, or the economic conditions in which transactions take place, could materially affect the amount charged, comparability under this method also depends on similarity with respect to these factors, or adjustments to account for material differences in such circumstances. Id.

If material differences exist between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on price or profits can be ascertained with sufficient accuracy to improve the reliability of the results. Treas. Reg. §1.482-1(d)(2). A material difference is one that would materially affect the measure of an arm’s length result under the method being applied. Id. 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. Id. The extent and reliability of any adjustments will affect the relative reliability of the analysis. Id. 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.

Treas. Reg. §1.482-1(d)(3)(ii)(C), Examples 1 and 2, illustrate the effects of differences in volume on comparability. In Example 1, a US parent (“USP”) buys transportation services from its foreign subsidiary (“FSub”). FSub also provides services to an unrelated domestic company (“URA”). URA accounts for 10% of FSub’s gross

³ Solely for purposes of analyzing the narrow question presented, we assume that you have determined that the CUT method is the best method in this case and disagree only with Taxpayer’s particular application of the CUT method, and we similarly further assume that (other than the question of the sales volume adjustments at issue) you have determined that the selected CUTs are sufficiently comparable to the controlled transactions under §1.482-4(c)(2)(ii).

revenues, and the remaining 90% are attributable to USP. The example concludes that in determining the degree of comparability between FSub's uncontrolled transaction with URA and the controlled transaction with USP, the difference in volume and the regularity with which services are provided must be taken into account if they would have a material effect on the price charged. Inability to make reliable adjustments for these differences would affect the reliability of the results.

In Example 2, a foreign subsidiary ("FS") manufactures a product and sells it to its parent at a price of \$100 per unit. In uncontrolled transactions, FS offers a 2% discount for quantities of 20 per order, and a 5% discount for quantities of 100 per order. The example concludes that if FS's parent purchases products in quantities of 60 per order, in the absence of other reliable information, it may be reasonably concluded that the arm's length price to the parent would be \$100, less a 3.5% discount. But if parent purchases products 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% discounts applicable to sales of 20 and 100 units, respectively.

ANALYSIS

In this case, it must first be determined whether the differences in sales volume between the controlled and uncontrolled transactions materially affect the measure of the arm's length result under the CUT method being applied. Treas. Reg. §1.482-1(d)(2). If it is determined that differences in sales volume do not materially affect the measure of the arm's length result, then no adjustment should be made. Based solely on the CUTs selected by Law Firm in the Studies -- and in particular, on the presence of a sales volume adjustment provision in only a small subset of the selected CUTs and on the lack of available sales volume data for many of the CUTs that do not have such provisions -- it is not immediately apparent whether sales volume has a material effect on the measure of an arm's length result under the CUT method applied by Taxpayer.

Second, if it is determined that a difference in sales volume material to the measure of the arm's length result exists, it must then be considered whether the effect of this difference can be ascertained with sufficient accuracy such that an adjustment would improve the reliability of the results. Id. If so, an adjustment to the results of the CUTs for this comparability difference should be made, though it would not be necessary to accept the specific adjustment proposed by Taxpayer if a different adjustment for sales volume based on commercial practices, economic principles, or statistical analyses would be more reliable. See id. If it is determined that an adjustment for sales volume would not improve the reliability of the results, the unadjusted CUTs may be used as a measure of an arm's length result (although the inability to reliably adjust for differences in sales volume may reduce the reliability of the analysis), provided they are nonetheless determined to be sufficiently reliable under §1.482-4(c)(2)(ii). Treas. Reg. §1.482-1(d)(2).

In summary, the determination of whether to adopt or reject a particular comparability adjustment is a matter to be resolved in your expert judgment within the regulatory framework described above.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (313) 628-3113 if you have any further questions.

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