



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I International Practice Service Transaction Unit

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Unit Name	Arm's Length Standard
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Issue and Transaction Overview

Arm's Length Standard

IRC section 482 provides the authority for the IRS to make allocations between controlled parties to clearly reflect the income of each of the parties. The arm's length standard is the standard the IRS has adopted for implementing the clear reflection of income principle for controlled transactions under IRC section 482. The arm's length standard is defined in the section 482 regulations.

This unit provides a basic introduction to the arm's length standard. The focus of this unit will be the purchase of tangible products by a U.S. subsidiary ("USS") from a foreign parent ("FP").

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. Generally, agreements are made by two uncontrolled parties freely and independently of each other. If a controlled relationship between the parties exists (i.e.; related party transaction), the result can be a transfer price that is not arm's length. These are called controlled transactions.

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.

Evaluation of whether a controlled transaction produces an arm's length result relies on and requires application of the best method analysis and other principles of section 482 and the regulations. The arm's length analysis begins with the factual and functional analysis of the actual transaction (or transactions) among the controlled parties.

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Issue and Transaction Overview (cont'd)

Arm's Length Standard

In determining whether the result of a controlled transaction is arm's length, taxpayers must use the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. This will be the best method. There is no priority of methods and no method will invariably be considered to be more reliable than others.

Methods for determining taxable income in connection with a controlled transfer of tangible property are:

- Comparable Uncontrolled Price ("CUP")
- Resale Price
- Cost Plus
- Comparable Profits Method ("CPM")
- Profit Split
- Unspecified Methods

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Transaction and Fact Pattern

Arm's Length Standard	
Diagram of Transaction	Facts
<p>The diagram illustrates the transaction between FP and USS. FP is represented by a blue box at the top, and USS is represented by a white box at the bottom. A straight arrow points from FP down to USS. Two large, curved green arrows are positioned around the boxes: one on the left side pointing from FP to USS, labeled 'Products', and one on the right side pointing from USS to FP, labeled 'Payment'.</p>	<ul style="list-style-type: none"> ▪ FP wholly owns USS. ▪ FP is a multi-national manufacturing company based in a foreign country. ▪ USS purchases tangible products from FP and distributes them throughout the US, performing only routine functions. ▪ USS filed a Form 1120. ▪ The tangible product does not include any embedded intangibles. ▪ USS selected a Comparable Profits Method (CPM) for pricing its related party transaction for tax purposes.

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Summary of Potential Issues

Arm's Length Standard	
Issue 1	Did USS's methodology for pricing the transaction with FP produce an arm's length price?
Issue 2	Does the pricing of the transaction fall within the "arm's length range" or does it require an adjustment?

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All Issues, Step 1: Initial Factual Development

Arm's Length Standard

Taxpayers sometimes use inappropriate pricing to shift income outside the United States. The pricing of all transactions between FP and USS must be arm's length. It is important to establish the facts and supporting documentation when performing a pricing analysis.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> Identify the parties to the transaction and determine which party should be the "tested party". 	<ul style="list-style-type: none"> Tax Returns (Form 1120/Form 5472) Organizational Chart (Worldwide) 	
<ul style="list-style-type: none"> Identify the transactions (product purchases) between USS and FP. Does USS identify a method to support its pricing? 	<ul style="list-style-type: none"> Form 5472, Purchases of Stock-in-Trade (Inventory) Transfer Pricing Studies Taxpayer's Financial Statements Contracts Intercompany Agreements Custom's Reports Transfer Pricing Roadmap 	
<ul style="list-style-type: none"> What specific and separate functions were performed by USS in relation to the transaction (product purchases)? 	<ul style="list-style-type: none"> Functional Analysis Functional Organization Chart Interviews of key personnel 	

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All Issues, Step 1: Initial Factual Development (cont'd)

Arm's Length Standard

Taxpayers sometimes use inappropriate pricing to shift income outside the United States. The pricing of all transactions between FP and USS must be arm's length. It is important to establish the facts and supporting documentation when performing a pricing analysis.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Determine if USS has any purchases of the same or similar product from uncontrolled parties. ▪ What is the percentage of total purchases by USS from FP? Is it material? ▪ Did FP make sales to uncontrolled parties of similar products? 	<ul style="list-style-type: none"> ▪ Form 1120 ▪ Form 5472 ▪ Financial Statements 	
<ul style="list-style-type: none"> ▪ What is the operating profit of USS as compared to its peers in the industry selling similar products? 	<ul style="list-style-type: none"> ▪ Perform Ratio Analysis 	


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Issue 1, Step 2: Review Potential Issues

Arm's Length Standard		
Issue 1		
Did USS's methodology for pricing the transaction with FP produce an arm's length price?		
Explanation of Issue	Resources	6103 Protected Resources
<p>Each case must be evaluated to determine the best method based upon the particular set of facts.</p> <p>The best method rule requires application of the transfer pricing method that, under the facts and circumstances, provides the most reliable measure of an arm's length price. The "arm's length standard" means controlled parties should price transactions in the same way as uncontrolled parties under similar circumstances. Accordingly, the price that FP charges USS should be the same as it would charge to an unrelated party for the same product under similar circumstances.</p> <p>The two primary factors are (1) degree of comparability and (2) the quality of the data and assumptions used in the analysis. Both must be carefully considered.</p> <p>The arm's length standard acknowledges that transactions identical to a particular controlled transaction can rarely be located. Comparability does not require that controlled and uncontrolled transactions be identical. Rather, they must be sufficiently similar that differences either will not materially effect the condition being examined, or permit a reasonably accurate adjustment for any material difference.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. §1.482-1(c) – Best Method Rule ▪ Treas. Reg. 1.482-3 – Methods to determine taxable income in connection with a transfer of tangible property ▪ Treas. Reg. §1.482-1(d) – Comparability ▪ IPS Unit – Comparability Analysis for Tangible Goods Transactions Inbound ▪ IPS Unit – Functional Analysis [under development] 	


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Issue 1, Step 2: Review Potential Issues (cont'd)

Arm's Length Standard		
Issue 1		
Did USS's methodology for pricing the transaction with FP produce an arm's length price?		
Explanation of Issue	Resources	6103 Protected Resources
 CONSULTATION: Make sure you consult with the Economist and/or the Transfer Pricing Practice (TPP) as needed.		


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Issue 1, Step 3: Additional Factual Development

Arm's Length Standard		
Issue 1		
Did USS's methodology for pricing the transaction with FP produce an arm's length price?		
Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> What are the functions performed, assets employed, and risks assumed by USS relating to the purchase of products from FP? <p> CAUTION: For this unit, we are assuming that USS is the tested party.</p>	<ul style="list-style-type: none"> Transfer Pricing Studies Annual Reports Interview key employees SEC Filings (Form 10K) Press Releases Capital IQ – Research Market Studies Internet Searches on taxpayer and industry Intercompany Agreements Contracts 	

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Issue 1, Step 3: Additional Factual Development (cont'd)

Arm's Length Standard		
Issue 1		
Did USS's methodology for pricing the transaction with FP produce an arm's length price?		
Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Did USS use the most reliable method to determine the arm's length price for the purchase of tangible products from FP? <ul style="list-style-type: none"> – comparability – quality of data – reliability of assumptions – sensitivity of results to possible deficiencies  CONSULTATION: Consult with an Economist, TPP, and/or Engineers as necessary.	<ul style="list-style-type: none"> ▪ Transfer Pricing Studies ▪ Intercompany Agreements ▪ Contracts ▪ Segmented Financial Statements ▪ Functional Organizational Charts ▪ Transfer Pricing Functional Analysis Questionnaire ▪ Interviews of key employees ▪ Annual Reports / SEC filings ▪ SIC – NAICS Classifications ▪ Transfer Pricing Roadmap ▪ Capital IQ – including market studies ▪ Research Insight ▪ Ratio analysis 	

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Issue 1, Step 4: Develop Arguments

Arm's Length Standard

Issue 1

Did USS's methodology for pricing the transaction with FP produce an arm's length price?

Explanation of Approach	Resources	6103 Protected Resources
<p>Develop the unique facts of the transaction through a functional analysis and select the transfer pricing method that provides the most reliable measure of an arm's length price under those facts.</p> <p>Determine the factors in the best method rule to apply the most reliable method. In this unit, we are assuming the CPM is the best method for this taxpayer.</p>	<ul style="list-style-type: none"> ▪ IRC 482 – Allocation Provision with Controlled Transactions ▪ Treas. Reg. §1.482-1(b)(1) – Arm's Length Standard ▪ Treas. Reg. §1.482-1(c) – Best Method Rule ▪ Treas. Reg. §1.482-2 – Methods for analyzing different types of transactions ▪ Treas. Reg. 1.482-3 – Methods for valuing transfers of tangible property 	


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Issue 1, Step 4: Develop Arguments (cont'd)

Arm's Length Standard		
Issue 1		
Did USS's methodology for pricing the transaction with FP produce an arm's length price?		
Explanation of Approach	Resources	6103 Protected Resources
<p>USS has selected the CPM method as their best method to analyze their transactions with FP.</p> <ul style="list-style-type: none"> ▪ Is the CPM method appropriate? ▪ Would another approach be considered the “best method” resulting in an arm’s length price? ▪ What factors were considered in the rejection or non-selection of the other methods available? 	<ul style="list-style-type: none"> ▪ Treas. Reg. §1.482-1(b)(1) – Arm’s Length Standard ▪ Treas. Reg. §1.482-1(c) – Best Method Rule ▪ Treas. Reg. §1.482-2 – Methods for analyzing different types of transactions ▪ Treas. Reg. 1.482-3 – Methods for valuing transfers of tangible property ▪ Transfer Pricing Study 	

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Issue 1, Step 4: Develop Arguments (cont'd)

Arm's Length Standard		
Issue 1		
Did USS's methodology for pricing the transaction with FP produce an arm's length price?		
Explanation of Approach	Resources	6103 Protected Resources
<p>Rejection of Methods</p> <ul style="list-style-type: none"> ▪ Comparable Uncontrolled Price (CUP) method is not appropriate since same or similar transactions could not be identified. ▪ Resale Price Method (RPM) is not appropriate since gross margin is not reliable as there are variations in accounting. ▪ Cost Plus method is not appropriate since USS is not a manufacturer. 	<ul style="list-style-type: none"> ▪ Treas. Reg. §1.482-1(b)(1) – Arm's Length Standard ▪ Treas. Reg. §1.482-1(c) – Best Method Rule ▪ Treas. Reg. §1.482-2 – Methods for analyzing different types of transactions ▪ Treas. Reg. 1.482-3 – Methods for valuing transfers of tangible property 	
 <p>DECISION POINT: Based on the operating ratios, pricing methodology employed, functions performed and risks taken, a decision must be made whether or not an issue exists. If so, determine best method.</p>	<p>IPS Unit: Best Method Determination for an Inbound Distributor, ISI/9422.09_05 (2013)</p>	

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Issue 2, Step 2: Review Potential Issues

Arm's Length Standard		
Issue 2		
Does the pricing of the transaction fall within the “arm’s length range” or does it require an adjustment?		
Explanation of Issue	Resources	6103 Protected Resources
<p>Sometimes a pricing method, such as a CUP, will produce a single result that is the most reliable measure of arm’s length pricing. Assuming that CUP is not applicable, all other methods may produce a number of results from which a range of reliable results can be derived. Since the requirements for use of the full range of comparable results are not often satisfied, the use of statistical analysis to create a more reliable result by use of the interquartile range is often used.</p> <p>USS will not be subject to adjustment if its results fall within such range—the arm’s length range.</p> <p>The arm’s length range includes the results of all comparable transactions. This can be determined either on a full range or an interquartile range.</p> <p>The full range can be used if the transactions meet all the following criteria:</p> <ul style="list-style-type: none"> ▪when the controlled and uncontrolled transactions are “sufficiently similar” ▪all material differences have been identified ▪adjustments are made to eliminate the effect of such differences. 	<ul style="list-style-type: none"> ▪ Treas. Reg. §1.482-1(e) – Arm’s Length Range ▪ Treas. Reg. 1.482-3 – Arm’s Length Range within Methods for Transfers of Tangibles ▪ Treas. Reg. §1.482-4 – Arm’s Length Range within Methods for Transfers of Intangibles ▪ Transfer Pricing Roadmap ▪ Transfer Pricing Studies 	


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Issue 2, Step 2: Review Potential Issues (cont'd)

Arm's Length Standard

Issue 2

Does the pricing of the transaction fall within the “arm’s length range” or does it require an adjustment?

Explanation of Issue	Resources	6103 Protected Resources
<p>The arm’s length range includes the results of all comparable transactions. This can be determined either on a full range or an interquartile range.</p> <p>The full range can be used if the transactions meet all the following criteria:</p> <ul style="list-style-type: none"> ▪ when the controlled and uncontrolled transactions are “sufficiently similar” ▪ all material differences have been identified ▪ adjustments are made to eliminate the effect of such differences <p>If the transactions do not meet the criteria to use a full range, a truncated range of arm’s length results will apply. The interquartile range of the comparable transactions – the results between the 25th and the 75th percentile - is used to determine the comparable prices and/ or profits..</p> <p> CONSULTATION: Consult with Economist and/or the TPP for additional analysis of the arm’s length range</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. §1.482-1(e) – Arm’s Length Range ▪ Treas. Reg. 1.482-3 – Arm’s Length Range within Methods for Transfers of Tangibles ▪ Treas. Reg. §1.482-4 – Arm’s Length Range within Methods for Transfers of Intangibles ▪ Transfer Pricing Roadmap ▪ Transfer Pricing Studies 	

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Issue 2, Step 3: Additional Factual Development

Arm's Length Standard

Issue 2

Does the pricing of the transaction fall within the “arm’s length range” or does it require an adjustment?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Did USS’s method develop a range of prices with respect to the transaction under review? ▪ Did USS’s price fall within this range? 	<ul style="list-style-type: none"> ▪ Transfer Pricing Studies ▪ USS’s Economist Report ▪ Industry Research Reports ▪ USS’s list of comparables ▪ IRS Economist Report ▪ IRS Engineer Report ▪ Outside Expert Report 	
<ul style="list-style-type: none"> ▪ Were USS’s results validated using multi-year average for internal data and/or external comparables? 		
<ul style="list-style-type: none"> ▪ Are USS’s comparables accurate for this transaction which might impact the range? 		

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Issue 2, Step 4: Develop Arguments

Arm's Length Standard

Issue 2

Does the pricing of the transaction fall within the “arm’s length range” or does it require an adjustment?

Explanation of Approach	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ As part of any adjustment to the arm's length range, address any weaknesses in USS's method. ▪ Did the IRS develop a different range of prices in respect to the transaction under audit and what pricing method was used by the IRS. ▪ The IRS method should include a full analysis of the rationale and the adjustment to the transfer price based on the appropriate range. ▪ The IRS can make an adjustment if USS's pricing is outside the appropriate arm's length range. 	<ul style="list-style-type: none"> ▪ Treas. Reg. §1.482-1(e) – Arm’s Length Range ▪ Treas. Reg. 1.482-3 – Arm’s Length Range within Methods for transfers of Tangibles 	

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Training and Additional Resources

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Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ FY2012 Transfer Pricing Introduction to 482 ▪ FY2013 IRC 482 Overview. 50767 (HLL028040) 	<ul style="list-style-type: none"> ▪ Transfer Pricing Introduction to 482 (QRP785958) FY2012. Overview and Introduction to IRC Sec 482 FINAL with BR 6 revisions.ppt
Issue Toolkits	<ul style="list-style-type: none"> ▪ IRM 4.61.3-4 Functional Analysis Questionnaire ▪ Checklist - IRC 482 Transfer Pricing Case Development Tool ▪ IRM 4.61.3 Development of IRC section 482 Cases 	<ul style="list-style-type: none"> ▪ Transfer Pricing Functional Analysis Questionnaire ▪ Checklist – IRC § 482 (Transfer Pricing) ▪ IRM 4.61.3 - Development of IRC 482 Issues
Other Training Materials	<ul style="list-style-type: none"> ▪ International Examiner Phase III Training, Module E-1, Overview of IRC 482 ▪ Bittker and Lokken, Fundamentals of International Taxation, Chapter 79,: Reallocation of Income and Deductions Among Related Taxpayers ▪ OECD Transfer Pricing Guidelines 	

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Glossary of Terms and Acronyms

Acronym	Definition
CUP	Comparable Uncontrolled Price
FP	Foreign Parent
IBC	International Business Compliance
IPN	International Practice Network
IRC	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business & International
NAICS	North American Industry Classification System
OECD	The Organisation for Economic Co-operation & Development
SIC	Standard Industry Code
TPO	Transfer Pricing Operations
TPP	Transfer Pricing Practice
UIL	Uniform Issue List
USS	United States Subsidiary

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Index of Related Issues

Issue	Associated UIL(s)	References
Overview of 482	9411.07	IPS Unit – Overview of IRC Section 482 DCN: ISI/9411.07_01(2013)
Tangible Goods-Inbound CUP	9422.07	IPS Unit – Purchase of Tangible Goods from a Foreign Parent CUP Method DCN: ISI/9422.07_09(2013)
Comparability for Inbound Distributor	9422.07	IPS Unit – Comparability Analysis for Tangible Goods Transactions Inbound DCN: ISI/9422.07_01 thru _06(2013)
CPM Simple Distributor Inbound	9422.07	IPS Unit – CPM Simple Distributor Inbound DCN: ISI/9422.07_07(2013)
Taxpayer's Use of IRC 482	9422.09	IPS Unit – Taxpayers Affirmative Use of IRC 482 DCN: ISI/9422.09_03(2013)
Three Requirements of IRC 482	9422.09	IPS Unit – Three Requirements of IRC 482 DCN: ISI/9422.09_02(2013)
Rev. Proc. 99-32	9422.09	IPS Unit – Rev. Proc. 99-32 Guidance DCN: ISI/9422.09_08(2013) Coming Soon
MAP Procedural Issues	9450.12	IPS Unit Coming Soon
Exchange of Information	9450.13	IPS Unit Coming Soon
Treaty-Based EOI	9460.01	IPS Unit Coming Soon
Penalties-Substantial	9560.11	IPS Unit Coming Soon
Penalties-Gross	9560.12	IPS Unit Coming Soon