DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: August 24, 2001

MEMORANDUM FOR: Jan E. Lamartine
Attorney CC:LM:RFP:CHI:2

FROM: Elizabeth Beck, Chief, CC:INTL:6

SUBJECT: Allocation of Losses under section 482 and Rev. Proc. 63-10

This Chief Counsel Advice responds to your memorandum dated March 21, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

CorpA =
CorpPR =
Affiliated GroupA =

Product =
Components =
Date1 =
Taxable Year A =
Taxable Year B =
Taxable Year C =
Taxable Year D =
Accounting FirmA =
AmountA =
AmountB =
AmountC =
AmountD =

AmountE =
AmountF =
AmountG =

ISSUE 1

Whether the location savings provision under section 3.02(3) of Rev. Proc. 63-10 applies to allocations of income and expenses related to goods manufactured and sold to a domestic corporation by its wholly-owned manufacturing subsidiary located in Puerto Rico when the subsidiary has in effect a cost sharing method election under section 936(h)(5)(C)(i).

ISSUE 2

Whether an island affiliate that manufactures Components and Products that are ultimately sold by its mainland affiliate at an overall loss and applies the cost plus or comparable profits method to determine allocations for market returns on routine contributions under the first step of the residual profit split method may, in the second step, allocate operating loss with respect to intangibles to the island affiliate and, thus, decrease the transfer price below the amount determined under section 3.02(3) of Rev. Proc 63-10.

CONCLUSION 1

The location savings provision under section 3.02(3) of Rev. Proc. 63-10 applies to allocations of income and expenses related to goods manufactured and sold to a domestic corporation by its wholly-owned manufacturing subsidiary located in Puerto Rico when the subsidiary has in effect a cost sharing method election under section 936(h)(5)(C)(i) and the subsidiary determines its transfer prices with respect to such sales using either the cost plus method under Treas. Reg. § 1.482-3(d), the comparable profits method under Treas. Reg. § 1.482-5 applied with respect to the subsidiary's manufacturing functions, or the residual profit split method under Treas. Reg. § 1.482-6(c)(3) where the cost plus or the comparable profits method is used in the first step to allocate a routine return to the subsidiary.

CONCLUSION 2

If an island affiliate manufactures Components and Products that are ultimately sold by its mainland affiliate at an overall loss and applies the cost plus or comparable profits method to determine allocations for market returns on routine contributions under the first step of the residual profit split method, the second step of the residual profit split method may not allocate operating loss with respect to intangibles to the island affiliate and, thus, may not decrease the transfer price below the transfer price determined under section 3.02(3) of Rev. Proc 63-10. However, overall losses on the manufacture and distribution of Components and Products may be allocated to the island affiliate under section 3.02(3) where the loss is properly associated with the routine manufacturing function of the island affiliate. This can occur, for example, where the island affiliate has assumed market (price) risk with respect to Components and Products manufactured by it and there is a market downturn, or where manufacturing inefficiencies or errors contribute to the realization of the loss.

FACTS

CorpA is a domestic subchapter C corporation and leading manufacturer of Product. CorpPR was a wholly-owned domestic subsidiary of CorpA from Date1 through Taxable Years A and B. CorpA and CorpPR belong to Affiliated GroupA. During Taxable Years A and B, CorpPR had in place a valid election under section 936(a) and (e) of the Internal Revenue Code to be a possession corporation to which section 936 applies. At all times relevant to this case, CorpPR continuously maintained its status as a possession corporation in accordance with the requirements under section 936 including the possession nexus requirements under section 936(a)(2).

During Taxable Years A and B, CorpPR assembled Components in Puerto Rico. CorpPR sold some Components to CorpA which, in turn, incorporated the Components into finished Products for sale or resold the Components as spare parts. CorpPR incorporated all other Components that it manufactured into finished Products which it sold to CorpA for resale. CorpPR’s manufacture of Components and Products for Taxable years A and B in Puerto Rico resulted in location savings although such location savings were a small percentage of total cost of goods sold. CorpA owns valuable marketing and manufacturing intangibles with respect to Components and Products.

CorpA and CorpPR agree with the Service that they are commonly controlled businesses within the meaning of section 482 and that the 1994 section 482 regulations apply to Taxable Years A and B. The parties further agree that CorpA and CorpPR were a mainland affiliate and island affiliate, respectively, within the meaning of Rev. Proc. 63-10. CorpA and CorpPR did not make a contract with respect to the allocation of market risk and acted as a joint venture engaged in the manufacture and sale of Components and Products.

For Taxable Year C and every subsequent taxable year through Taxable Years A and B, CorpPR timely elected under section 936(h)(5)(C)(i) to use the cost sharing method for computing its taxable income. Accordingly, for Taxable Years A and B, CorpPR was treated as owning valuable manufacturing intangibles related to Products and Components.

For Taxable Year C through Taxable Year D (the 10 year period immediately before Taxable Year A), CorpA and CorpPR determined the transfer prices for sales of the Components and Products by CorpPR to CorpA using a profit split method. On its Federal income tax returns for Taxable Years A and B, CorpPR used the cost plus method of Treas. Reg. § 1.482-3(d) to determine its transfer prices for sales of Components and Products to CorpA. The mark-up, however, was AmountA% less than reported in the prior taxable years that CorpA and CorpPR had used the profit split method.

After Taxable Year B, CorpA commissioned Accounting FirmA to conduct a transfer pricing study of its transactions with CorpPR to satisfy the requirements of section 6662(e). Accounting FirmA determined that use of the cost plus method was not justified because of the lack of third party publicly-held Component and Product manufacturers. Accounting FirmA advised CorpA that the comparable profits method under Treas. Reg. § 1.482-5 was the best method for determining transfer prices between CorpA and CorpPR. CorpA, however, did not file amended returns to reflect a change to the comparable profits method (using CorpPR as the tested party) for Taxable Years A and B because the comparable profits and cost plus methods resulted in similar tax liabilities in those years.

Affiliated GroupA reported consolidated operating losses with respect to the production and sale of Components and Products of $AmountB and $AmountC in Taxable Years A and B, respectively. More specifically, by using the cost plus/comparable profits method during Taxable Years A and B in conjunction with the allocation rules under Rev. Proc. 63-10, CorpPR reported profits of $AmountD and $AmountE in Taxable Years A and B, respectively. In contrast, CorpA reported losses of $AmountF and $AmountG in Taxable Years A and B, respectively, on the same transactions. For many years prior to Taxable Year A, Affiliated GroupA's sales of Components and Products had yielded consistent and substantial profits. The economist assigned to the examination states that the loss was primarily due to a downturn in market demand for Components and Products, rather than any particular act of CorpA or CorpPR.

The Service maintains the following two independent positions. First, Rev. Proc. 63-10 does not apply to CorpPR because Affiliated GroupA reported an overall loss during Taxable Years A and B with respect to the manufacture and sale of Components and Products. In support of this argument, the Service points to the "without incurring a loss" language in section 3.02(3) of Rev. Proc. 63-10. Second, application of an arm's length method under the 1994 section 482 regulations for determining transfer prices for the sales of Components and Products by CorpPR to CorpA should not result in a profit for CorpPR because Affiliated GroupA incurred an overall loss. Accordingly, the Service proposes certain section 482 adjustments that would cause CorpPR to bear a proportionate share of the Affiliated GroupA overall loss with respect to the

Components and Products that it manufactured and, thus, disallow the allocation of location savings to CorpPR under the revenue procedure.

LAW AND ANALYSIS

I. Law

A. Section 936 and Possession Corporations

1. Generally

A domestic corporation that has a section 936(a) election in effect is called a "possession corporation." I.R.C. § 936(i)(6). Section 936 provides a qualified possession corporation a credit against the United States income tax attributable to certain income.

Special rules apply to a possession corporation's income that is attributable to intangible property. Such "intangible property income" is included on a pro rata basis in the gross income of the possession corporation's shareholders as U.S.-source income and is excluded from the gross income of the corporation. I.R.C. § 936(h)(1). However, if a possession corporation makes an election under section 936(h), the allocation of intangible property income rule under section 936(h)(1) does not apply for that taxable year or subsequent taxable years for which the election remains in effect. I.R.C. § 936(h)(5)(A) and (B). A possession corporation that has a section 936(h) election in effect is called an "electing corporation." I.R.C. § 936(h)(5)(E). If a possession corporation elects one of two alternative methods

> with respect to a product or type of service, [the] corporation shall compute its income derived from the active conduct of a trade or business in a possession with respect to such product or type of service in accordance with the method which is elected.

I.R.C. § 936(h)(5)(C). The two alternative elective methods are the cost sharing method and the profit split method. Id.

2. The Cost Sharing Method Election Under Section 936(h)(5)(C)(i)

A corporation that elects the cost sharing method ("CSM") must make a payment to its affiliated group for its share of the affiliated group's product area research expenditures paid or accrued during the taxable year. I.R.C. § 936(h)(5)(C)(i)(I). For purposes of section 936(h), "affiliated group" means the electing corporation and all other organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, within the meaning of section 482. I.R.C. § 936(h)(5)(C)(i)(I)(b).

Section 936(h)(5)(C)(i)(II) provides that for purposes of determining the amount of an electing corporation's gross income derived from the active conduct of a trade or business in a possession with respect to a product produced by, or type of service rendered by, it, an electing corporation that validly elects the CSM shall be treated as "the owner (for purposes of obtaining a return thereon)" of manufacturing intangibles related to such product or services. See also Notice 88-123, 1988-2 C.B. 458, 498 (explaining the fact that the amount paid by an electing corporation pursuant to the CSM under section 936(h)(5)(C)(i) entitles the corporation to be treated as the owner of manufacturing intangibles previously developed by its U.S. affiliates). For purposes of section 936(h), manufacturing intangibles include patents, inventions, formulas, processes, designs, patterns, and knowhow. I.R.C. § 936(h)(3)(B)(i). The electing corporation is not treated as owning any marketing intangibles developed by its affiliates as a result of its CSM election. I.R.C. § 936(h)(5)(C)(i)(II).

If an election to use the CSM is in effect,

> the electing corporation shall determine its intercompany pricing under the appropriate section 482 method, provided, however, that an electing corporation shall not be denied use of the resale price method for purposes of such intercompany pricing merely because the reseller adds more than an insubstantial amount to the value of the product by the use of intangible property.

I.R.C. § 936(h)(5)(C)(i)(IV)(b). That is, a U.S. affiliate and its possession corporation subsidiary must use the appropriate section 482 method to determine the transfer prices of the products manufactured by the possession corporation and sold to the U.S. affiliate.

B. Section 482 Transfer Pricing Methods

1. The Best Method Rule

Section 482 provides that the Secretary may allocate income, deductions, credits, and allowances between two or more commonly controlled organizations, trades, or businesses in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. The 1994 section 482 regulations apply to taxable years beginning after October 6, 1994. Treas. Reg. § 1.482-1(j)(1). Taxpayers may elect to apply the 1994 section 482 regulations retroactively for any open taxable year. Treas. Reg. § 1.482-1(j)(2).

The section 482 regulations place a controlled taxpayer on a parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. Treas. Reg. § 1.482-1(a)(1). A "controlled taxpayer" is any one of two or more taxpayers owned or controlled directly or indirectly by the same interests and includes the taxpayer that owns or controls the other taxpayers. Treas. Reg. § 1.482-1(i)(5). An "uncontrolled taxpayer" is any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests. Id. The term "controlled" refers to

> any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise.

Treas. Reg. § 1.482-1(i)(4).

"True taxable income" of a controlled taxpayer means the taxable income that would have resulted if such taxpayer had dealt with other members of its group at arm's length. Treas. Reg. § 1.482-1(i)(9). "Group" refers to taxpayers owned or controlled directly or indirectly by the same interests. Treas. Reg. § 1.482-1(i)(6). Treas. Reg. § 1.482-1(b)(1) provides that

> [i]n 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. . . . 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 is made pursuant to a method selected under the best method rule described in § 1.482-1(c).

Under the best method rule,

> [t]he 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.

Treas. Reg. § 1.482-1(c).

In determining which method provides the most reliable measure of an arm's length result, one of the two primary factors is the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled transaction (or taxpayer). Treas. Reg. § 1.482-1(c)(2). A "controlled transaction" is a transaction between two or more members of the same group; an "uncontrolled transaction" is a transaction between two or more taxpayers that are not members of the same group. Treas. Reg. § 1.482-1(i)(8). Comparability factors that must be considered include functions,[1] contractual terms,[2] risks,[3] economic conditions,[4] and property or services (including embedded intangibles).[5] Treas. Reg. § 1.482-1(d)(1). In the absence of a written agreement, the Service may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2) and (iii)(A)(1).

The other primary factor in determining which method provides the most reliable arm's length result is the quality of the data and assumptions used in the analysis. Treas. Reg. § 1.482-1(c)(2). For instance, the completeness and accuracy of data affects the ability to identify and quantify factors that would affect the arm's length result under any particular method. Treas. Reg. § 1.482-1(c)(2)(ii)(A). Similarly, the reliability of an arm's length result depends on the soundness of certain assumptions. Treas. Reg. § 1.482-1(c)(2)(ii)(B). Finally, "[d]eficiencies] in the data used or assumptions made may have a greater effect on some methods than others." Treas. Reg. § 1.482-1(c)(2)(ii)(C).

The comparability and quality of data and assumptions rules under Treas. Reg. § 1.482-1(c) and (d) apply generally to all arm's length methods. However, Treas. Reg. §§ 1.482-3 through 1.482-6 each give specific guidance with respect to comparability and reliability cosiderations. T.D. 8552, 1994-2 C.B. 93, at 99.[6]

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[1] See Treas. Reg. § 1.482-1(d)(3)(i).

[2] See Treas. Reg. § 1.482-1(d)(3)(ii).

[3] See Treas. Reg. § 1.482-1(d)(3)(iii).

[4] See Treas. Reg. § 1.482-1(d)(3)(iv).

[5] See Treas. Reg. § 1.482-1(d)(3)(v).

[6] See, e.g., Treas. Reg. §§ 1.482-3(b)(2), (c)(3), and (d)(3); 1.482-4(c)(2); 1.482-5(c); and 1.482-6(c)(2)(ii) and (3)(ii).

2. <u>The Arm's Length Methods</u>

The arm's length price charged in a controlled transfer of tangible property must be determined under one of the six following methods: comparable uncontrolled price method, resale price method, cost plus method, comparable profits method, profit split method, and unspecified methods.[7] Treas. Reg. § 1.482-3(a).

Under the comparable uncontrolled price method, the arm's length price in a controlled transaction is equal to the price paid in a comparable uncontrolled transaction. Treas. Reg. § 1.482-3(b)(1).

Under the resale price method, the arm's length price in a controlled sale is the price that reflects a gross profit margin equal to the gross profit margin realized in a comparable uncontrolled transaction. Treas. Reg. § 1.482-3(c)(1).

Under the cost plus method, the arm's length price is the cost of production of the controlled taxpayer increased by the gross profit mark-up realized in a comparable uncontrolled transaction. Treas. Reg. § 1.482-3(d)(1) and (2).

Under the comparable profits method, the arm's length price is the price that reflects the operating profit that the controlled taxpayer would have realized if its profit level indicator were equal to that realized in a comparable uncontrolled transaction. Treas. Reg. § 1.482-5(b)(1).

Under the profit split method, the arm's length price in a controlled transaction is the price that provides to each controlled taxpayer a share of combined operating profit or loss that reflects the relative value of each controlled taxpayer's contribution to the combined operating profit or loss. Treas. Reg. § 1.482-6(a). Allocation of profit or loss under the profit split method must follow one of two methods – the comparable profit split and the residual profit split methods. Treas. Reg. § 1.482-6(c)(1). Under the former method, a comparable profit split is derived from the relative allocations of operating profit or loss of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Treas. Reg. § 1.482-6(c)(2)(i).

Under the residual profit split method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers pursuant to a two-step process. Treas. Reg. § 1.482-6(c)(3)(i). In the first step, operating income is allocated to each controlled taxpayer to provide a market return for its routine

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[7] Because the taxpayer and the Service agree to the extent that one of the enumerated methods applies in this case, this advice does not address the issue of unspecified methods under Treas. Reg. § 1.482-3(e).

contributions to the relevant business activity. Treas. Reg. § 1.482-6(c)(3)(i)(A). "Routine contributions" ordinarily include contributions of tangible property, services, and intangible property of the type generally owned by uncontrolled taxpayers engaged in similar activities. Id. Market returns on routine contributions are determined by applying the best method available under Treas. Reg. §§ 1.482-3 through 1.482-5. Id. In the second step, the residual profit or loss after the first allocation of income, if any, is allocated to the controlled taxpayers in proportion to their relative contributions of valuable intangible property not accounted for as a routine contribution. Treas. Reg. § 1.482-6(c)(3)(i)(B).

C. Rev. Proc. 63-10 and Allocation of Income and Expenses between Mainland Affiliates in the United States and Island Affiliates in Puerto Rico

Rev. Proc. 63-10, 1963-1 C.B. 490, sets forth guidelines for the application of section 482 in cases involving the allocation of income and expenses between United States companies ("mainland affiliates") and their manufacturing subsidiaries in Puerto Rico ("island affiliates"). Rev. Proc. 68-22, 1968-1 C.B. 819, 821, provides that, after the issuance of regulations under section 482, Rev. Proc. 63-10 continues to apply to

> cases involving the allocation of income and deductions between U.S. companies and their manufacturing affiliates in Puerto Rico, if the result is more favorable to the taxpayer than the result under the regulations prescribed by Treasury Decision 6952.[8]

The legislative history of section 936(h), which was enacted in 1982, provides that

> [t]he regulations under section 482 and Internal Revenue Service revenue procedures (Revenue Procedure 63-10, as amplified by Revenue Procedure 68-22) will continue to apply except to the extent modified by the [CSM] election.

H.R. Conf. Rep. No. 97-760, at 510 (1982).

Section 3.02(3) of Rev. Proc. 63-10 provides that a section 482 transfer price paid to an island affiliate and determined under a cost plus method may take into account location savings resulting from manufacture in Puerto Rico. Specifically, section 3.02(3) of Rev. Proc. 63-10 provides that, in situations where no independent prices are available, and the product involved

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[8] Treasury Decision 6952 contained the 1968 section 482 regulations.

> represents a type which is manufactured in the United States or for which it is reasonable to assume that the mainland affiliate could, without incurring a loss, have contracted for United States manufacture, the price . . . necessary to induce an independent United States firm to produce in the United States the product in question for the mainland affiliate in the quantities involved constitutes the best approximation of the applicable arm's length price, subject to appropriate adjustment for differences, if any, in costs incident to transportation.

1963-1 C.B. at 494. A similar rule determines the amount of location savings allocated to the island affiliate with respect to foreign costs of manufacture where profitable U.S. manufacture is not possible and manufacturers in a foreign country dominate the U.S. market. In such a case,

> the arm's length price should be based on the costs, including United States import duties, and profit which is representative for the type of manufacturing activities involved in the country which dominates the United States market for the product.

Id. at 495. In essence, section 3.02(3) of Rev. Proc. 63-10 provides an allocation of all location savings to the island affiliate where the location savings rule under Treas. Reg. § 1.482-1(d)(4)(ii)(C) would otherwise yield a different result. However, section 3.02(3) also provides that in the event location savings do not exist – for example, where market prices are based on low cost manufacturing in a foreign country – the island affiliate's profit will not be increased when costs in Puerto Rico are higher than in the foreign country.

Section 4 of Rev. Proc. 63-10 permits an increase to a transfer price, as determined under section 482 and subject to the location savings provision under section 3, to reflect a return on intangibles treated as owned by the island affiliate. Section 4.01 of Rev. Proc. 63-10 contains rules for determining the allocation of income from intangibles between mainland and island affiliates and provides

> that if intangibles are present in a particular case and belong in whole or in part to the island affiliate, income properly allocable to the island affiliate will be higher than the arm's length price determined under the provisions of paragraph .02 of section 3. <u>In no case will the price allowed to the island affiliate be less than the arm's length price determined in accordance with section 3, above.</u>

Id. (emphasis added.)

II. Analysis

A. Section 936, CSM Election, and Section 482 Apply

For Taxable Years A and B, the possession corporation income tax credit provisions under section 936 applied to CorpPR. Pursuant to section 936(h), CorpPR elected to use the CSM for determining its Federal income tax liability. Accordingly, CorpPR made a cost sharing payment and, in return, was treated as owning all manufacturing intangibles related to Components and Products. CorpPR did not own, and was not treated as owning, any other intangibles with respect to Components and Products. As a result of making the CSM election, the appropriate section 482 method applied for the purpose of determining transfer prices between CorpPR and CorpA on sales of Components and Products.

B. Overall Loss not Contrary to Application of Rev. Proc. 63-10

The Service points to language in section 3.02(3) of Rev. Proc. 63-10 to support its argument that the revenue procedure does not apply in overall loss situations such as Affiliated GroupA's losses of $AmountB and $AmountC in Taxable Years A and B, respectively, on sales of Components and Products. This language states that, where no independent prices are available, and the product involved

> represents a type which is manufactured in the United States or for which it is reasonable to assume that the mainland affiliate could, without incurring a loss, have contracted for United States manufacture, the price . . . necessary to induce an independent United States firm to produce in the United States the product in question for the mainland affiliate in the quantities involved constitutes the best approximation of the applicable arm's length price, subject to appropriate adjustment for differences, if any, in costs incident to transportation.

1963-1 C.B. at 494 (emphasis added). The Service asserts that the "without incurring a loss" language prevents the application of Rev. Proc. 63-10 to an island affiliate if its affiliated group sustains an overall loss with respect to its products.

We disagree. The "without incurring a loss" language is not a requirement or prerequisite for the application of Rev. Proc. 63-10. Rather, "without incurring a loss" is a factor that contributes to the determination of the location savings allocable to the island affiliate under Rev. Proc. 63-10. If profitable manufacture of the product in the United States is not possible, location savings, if any, are determined taking into account the costs and profit of a foreign manufacturer in the country that dominates the U.S. market for the product.

Therefore, "without incurring a loss" does not prevent the application of Rev. Proc. 63-10 to the sales of Components and Products that resulted in an overall loss for Affiliated GroupA.

C. Interaction of Rev. Proc. 63-10 Location Savings and Appropriate Section 482 Method

For Taxable Years A and B, Rev. Proc. 63-10 applied to CorpPR. While the section 482 regulations apply to determine CorpPR's transfer prices pursuant to section 936(h)(5)(C)(i)(IV)(b), Rev. Proc. 63-10 must be taken into account when certain arm's length methods apply.

Pursuant to section 936(h)(5)(C)(i)(IV)(b), the taxpayer must apply the best method under the section 482 regulations to determine transfer prices for sales of Components and Products. The cost plus method determines transfer prices with respect to the costs incurred by the taxpayer. The comparable uncontrolled price, resale price, and comparable profit methods determine transfer prices with respect to prices charged in comparable uncontrolled transactions. The comparable profit split method determines transfer prices with respect to the allocation of profit or loss to uncontrolled taxpayers engaged in similar activities. The residual profit split method determines transfer prices under a two-step formula. First, operating income is allocated to each party to the controlled transaction to provide a market return for its routine contributions as determined under the best method available under Treas. Reg. §§ 1.482-3 through 1.482-5. Second, if valuable intangibles are present, the remaining profit or loss not allocated in the first step is divided among each party based upon the relative value of their contributions of intangible property not taken into account as routine contributions.

The Service has determined that the appropriate transfer pricing method for the controlled transactions is the residual profit split method. Under this transfer pricing method, section 3.02(3) and 4.01 of Rev. Proc. 63-10 work together in the following manner. Section 3.02(3) governs the allocation of income (or loss) to account for the routine contributions of the controlled taxpayers (after taking location savings into account), while section 4.01 governs the allocation of income (or loss) to account for nonroutine contributions. Per section 4.01, the return (or loss) attributable to the island affiliate's nonroutine contributions cannot reduce its return for routine contributions. However, nothing in either section 3.02(3) or 4.01 guarantees that the return to the island affiliate for its routine contributions be positive (or a profit). Thus, in the event a proper comparability analysis suggests that the return for the island affiliate's routine functions performed, resources employed, and assets is a negative return (which may also arise on account of particular market circumstances), the island affiliate may properly share in the loss to which it contributed. This can occur, for example, where the island affiliate has assumed market (price) risk with respect to Components and Products manufactured by it and there is a market downturn, or where manufacturing inefficiencies or errors contribute to the realization of the loss.

Please call the branch at 202-874-1490 if you have any further questions.

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