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May 4, 2016

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on T.D. 9738

Dear Commissioner Koskinen:

Enclosed please find comments on Treasury Decision 9738 ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

CCs: Hon. William Wilkins, Chief Counsel, Internal Revenue Service
Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
Steven Musher, Associate Chief Counsel (International), Internal Revenue Service
Frank Dunham III, Attorney-Advisor, Office of the Associate Chief Counsel (International), Internal Revenue Service
Hon. Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
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Robert Stack, Deputy Assistant Secretary (International), Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON TREASURY DECISION 9738

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing the Comments was exercised by John M. Breen of the Section’s Transfer Pricing Committee (the “Committee”). Substantive contributions were made by Jonathan Hunt, Kenneth Christman, Christine Hooks, Joseph Tobin, George Korenko, Paul Burns, John Woodruff, Sanford Stark, Jenny Austin, Fred Murray, and Star Lopez. The Comments were reviewed by Tracy Gomes, Vice-Chair of the Committee. The Comments were further reviewed by Carol Tello, the Section’s Council Director for the Committee, Sean Foley, on behalf of the Section’s Committee on Government Submissions, and Peter Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member of the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 4, 2016

SUMMARY OF COMMENTS

The following comments (the "Comments") on behalf of the Transfer Pricing Committee address Treasury Decision 9738 (T.D. 9738).

T.D. 9738 issued temporary regulations concerning the aggregation of controlled transactions in section 1.482-1(f)(2)(i). T.D. 9378 provides guidance concerning the analysis of controlled transactions that involve transfers of intangible property. Among other things, the temporary regulations anticipate that certain transactions may be evaluated on an aggregate basis if they are subject to analysis under section 482 and another provision of the Code, such as section 367(d), or if they are analyzed under multiple provisions of the section 482 regulations. Essentially, the temporary regulations call for increased aggregation and a "coordinated best method analysis," which would take into account "all value" associated with the controlled transactions, to include any transfers or contributions that might be considered related to the controlled transactions.

The Comments address a number of procedural and substantive issues. As a procedural matter, the temporary regulations were effective upon publication. In our view, this is inappropriate given that we believe that they may make substantive changes which are not mere "clarifications" of existing law, as the Preamble suggests.

As a substantive matter, the Comments make several observations regarding the temporary regulations, including the following: (1) because the term "all value" is not defined, its practical application may be uncertain; (2) requiring a determination of "all value" associated with controlled transfers potentially conflicts with the arm's length standard; (3) the approach in the regulations is equivalent to requiring taxpayers to include goodwill and going concern value in valuation of assets; (4) the regulations broaden the Commissioner's existing authority to re-cast transactions by reference to economic substance or to consider alternative transactions realistically available to the taxpayer; and (5) the revised aggregation provision will require coordination and integration with the existing guidance under section 482 (including, but not limited to, the best method rule in Regulation section 1.482-1(c)). The Comments also address several technical issues associated with aggregation under the temporary regulations.

I. INTRODUCTION

We are pleased to have the opportunity to provide comments and suggestions concerning Treasury Decision 9738. The Treasury Decision addresses several challenging issues in transfer pricing and related areas of taxation. However, given the importance of this area in U.S. administrative tax practice, and more broadly, in view of the changes expressed in these rules, we have concerns that the regulations represent a substantial departure from prior practice.[1] In our view, the temporary regulations do more than "clarify" existing rules, as well as create uncertainty, as explained in more detail below.

The temporary regulations introduce a number of terms and concepts that would benefit from more specific definitions. For example, the regulations call for a new "coordinated best method analysis and evaluation."[2] The existing best method rule already requires that all facts and circumstances be taken into account in determining "the most reliable measure of an arm's length result." The "coordinated best method analysis [requires]… a consistent consideration of the facts and circumstances of the functions performed, resources employed, and risks assumed in the relevant transactions, and a consistent measure of the arm's length result for purposes of all relevant statutory and regulatory provisions." The relationship between these two concepts is unclear. Does the new coordinated best method analysis take account of factors other than the relative reliability of the potential transfer pricing methods? Also, how does one use the best method rule "for purposes of all relevant statutory and regulatory provisions," i.e., for purposes of provisions other than section 482?[3]

The temporary regulations require the consideration for certain transfers to "be consistent with, and . . . account for <u>all of the value provided</u> between the parties in the transaction, without regard to the form and character of the transaction."[4] This sentence introduces a new concept, "all value," which does not appear in the existing regulations. It appears that the Service intends to incorporate the value associated with goodwill into the consideration for controlled transactions, a proposition that has been contained in the Treasury Department's Green Book during each of the last several years. If that is in fact the intent, a clear statement to that effect, along with definitions and more detailed guidance, would be useful.

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1 T.D. 9738, 2015-40 I.R.B. 453. Proposed regulations under I.R.C. § 367(d) were issued on the same date as T.D. 9738 (September 14, 2015), and were published in the same issue of the Internal Revenue Bulletin, REG-139483-13, 2015-40 I.R.B. These comments are limited to issues that relate to section 482.

2 *See* Reg. § 1.482-1T(f)(2)(i)(C).

3 References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

4 *See* Reg. § 1.482-1T(f)(2)(i)(A) (emphasis added). For simplicity, these comments use the term "all value" to refer to "all of the value provided between the parties in the transaction," except where a specific reference is made to the regulation or the Preamble.

We acknowledge many of the policy and enforcement concerns identified in the Preamble. For instance, we are prepared to accept that, in the case of two closely analogous transactions, minor changes to the legal structure of the transaction or the "label" applied to particular elements of the transaction should not affect the basic economics, much less the analysis of the transaction under section 482 or other, related Code provisions. With some reservations, we also agree that a taxpayer's transfer pricing analysis of an integrated transaction should generally align with the analysis of that transaction under other Code sections, including section 367(d). At the same time, it appears that the temporary regulations address certain potentially abusive situations by broadening the Commissioner's authority to reconfigure controlled transactions – an authority that has historically been limited to a small category of situations. Clearly, in certain circumstances, the Commissioner can evaluate the arm's length price of a controlled transaction based on the economic substance of the transaction, rather than the stated contractual terms adopted by the parties.[5] However, the Commissioner's authority in this regard has not previously extended to analysis of "all value," much less to an entire category of controlled transactions. We discuss these and other issues in the following comments.

II. COMMENTS ON THE REGULATIONS

A. <u>In Several Respects, the Temporary Regulations Appear to Conflict with the Existing Regulations under Section 482</u>

1. <u>The Term "All Value" is Undefined</u>

Section 1.482-1T(f)(2)(i)(A) of the temporary regulations provides that, "all value provided between controlled taxpayers in a controlled transaction requires an arm's length amount of compensation under the best method rule of §1.482-1(c)." According to the Preamble, this provision contemplates that all transfers between controlled taxpayers are analyzed and all property, services, or commercially transferable interests received in a controlled transaction receive compensation under section 482.[6] However, the plain language of sub-paragraph (A), which introduces the "all value" concept, goes somewhat farther than that. Rather than merely requiring all transactions or all transferred property to be identified and analyzed, this provision suggests that one must determine "all possible value" of the controlled transactions.

As already noted, the term "all value" is itself ambiguous. We are aware that the Service and the Organization for Economic Cooperation and Development ("OECD") have taken the view that value for financial accounting purposes is often understated, at least in the case of intangible property. The OECD has sought to define goodwill and going concern value as compensable intangibles. The Service and the Treasury "Green Book" have taken a similar view. If in fact the temporary regulations encompass goodwill and going concern value, they should say so explicitly. At present, this provision makes it more likely that a taxpayer's well-intentioned determination of the arm's length result will be rejected in favor of a subjective computation of

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5 *See* Reg. § 1.482-1(d)(2)(ii)(B).

6 *See* T.D. 9738, 2015-40 IRB 453 (Preamble). *See also* Reg. § 1.482-1T(f)(2)(i)(E), Ex. (6).

"all value." Overall, the regulations increase the range of determinations that may result (on the part of taxpayers and examiners) with regard to "all value."[7]

This new approach also departs from the way that uncontrolled taxpayers behave when they transfer property or services. In general, the existing regulations mandate an "arm's length result." "Under this standard, controlled taxpayers should price their controlled transactions by reference to the prices that would obtain among uncontrolled taxpayers, if they engaged in the same or similar transactions under comparable circumstances."[8]

Uncontrolled taxpayers that deal with one another at arm's length take into account various factors, which may or may not correlate with economic value.[9] Hence, the compensation agreed upon by uncontrolled parties may not correspond to "all value" within the meaning of the temporary regulations. Requiring controlled taxpayers to provide compensation for the full economic value associated with the transaction conflicts with the arm's length standard, to the extent that uncontrolled parties may and often do leave some value "on the table."

We are aware of certain uncontrolled transactions that involve discrete assets, including intangible property, e.g., patents, trademarks, copyrights, etc., in which the parties provide no increment of value, beyond the actual transaction price —that is, no goodwill value attaches to specifically identifiable assets. Similarly, in many joint ventures that involve bundled assets, including intangible assets, services and other contributions, no residual value is present beyond the consideration exchanged by the uncontrolled parties.

Under these circumstances, we recommend that the regulations not adopt the concept of "all value," at least not in its present form. This provision departs from existing practice, and calls for analysis that extends beyond the traditional focus of section 482, by calling for a subjective analysis on the part of the examiner.

We suggest that the first sentence of Regulation section 1.482-1T(f)(2)(i)(A) be revised to read: "All transactions between controlled taxpayers must be identified, and all property, services, or other commercially transferable interests exchanged between controlled taxpayers in a controlled transaction require compensation consistent with an arm's length result determined under the best method rule of section 1.482-1(c)." In the second sentence, we recommend that the term "all value provided between controlled taxpayers in a controlled transaction" be replaced with "the property, services, or other commercially transferable interests." We believe that efforts to link economic value to the arm's length price for a specific controlled transaction (or group of controlled transactions, evaluated in the aggregate) are fraught with difficulty. The edits suggested above would ensure that valuations for purposes of multiple sections of the Code or

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7 These comments focus on the outbound transfer scenario. The temporary regulations presumably also apply to inbound transfers of intangible property, and in that context they could offer opportunities for determinations of "all value" that are be detrimental to the U.S. fisc.

8 T.D. 8552, 1994-2 C.B. 93.

9 Examples include factors such as control and cost synergies.

regulations focus on the actual items that have value, rather than pursuing an economic construct that is poorly defined and possibly biased.

2. The Commissioner Should Not Override Contractual Terms that Accord with Economic Substance for Purposes of Aggregation

The temporary regulations refer to "economic substance" and state that a controlled transaction should be analyzed "without regard to [its] form or character."[10] Again, while we recognize the underlying policy concerns identified in the Preamble, it is not apparent that the abuses identified warrant a far-reaching reconfiguration of the arm's length standard.

One of the examples in the temporary regulations[11] shows the Service imputing additional contractual terms that were not formalized by the controlled parties but that might be implied based on their course of conduct. Example 6 describes this authority as follows: "[T]he Commissioner may impute one or more agreements . . . that fully reflect [the parties'] respective reasonably anticipated commitments in terms of functions performed, resources employed, and risks assumed over time."[12]

When the language in sub-paragraph (A), which indicates that compensation should be determined without regard to the form of the transaction, is considered in light of these references to "economic substance," the suggestion is that the Commissioner may disregard the controlled taxpayers' transactions or restructure them, even if they have economic substance. In a specific case, this provision could allow the Commissioner to disregard a license agreement that possesses economic substance and to recast the transaction instead as a sale of intangible property. We are concerned that the temporary regulations fail to put clear limits on the authority of the Commissioner in this regard.

These provisions seem to allow the Commissioner to disregard the terms of a controlled transaction, without first concluding that the terms are inconsistent with economic substance. If so, that approach conflicts with Regulation section 1.482-1(f)(2)(ii)(A), which provides that "The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance."[13]

The existing regulations permit the Commissioner to consider realistic alternatives, but only for purposes of evaluating the consideration paid under those alternatives and, if appropriate,

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[10] Reg. § 1.482-1T(f)(2)(i)(A).

[11] Reg. § 1.482-1T(f)(2)(i)(E), Ex. (6).

[12] *Id.* Each of the examples in the temporary regulations that show the Commissioner imputing contractual terms deal with situations in which the controlled taxpayer failed to specify contractual terms. Analytically, there is a difference between cases where: (1) the Commissioner imputes new contractual terms based on the economic substance of the activities and (2) the Commissioner rejects existing contractual terms because he concludes that they conflict with the economic substance of the activities. *See* Reg. § 1.482-1(d)(3)(ii)(B)(1) and -1(d)(3)(ii)(B)(2) (describing both aspects of this authority).

[13] Reg. § 1.482-1(f)(2)(ii)(A).

adjusting the consideration in the controlled transaction accordingly.[14] Importantly, the Commissioner "will not restructure the transaction as if the alternative [transaction] had been adopted by the taxpayer."[15] The realistic alternatives provision, as currently understood, does not authorize the Commissioner to alter the terms of the underlying transaction from the ones the controlled taxpayers adopted. That is a distinct authority, which comes into play only when the parties failed to specify contractual terms or when they specified contractual terms that do not accord with the economic substance of the controlled parties' dealings.

To the extent that the temporary regulations permit the Commissioner to disregard the transactional structure adopted by the controlled taxpayer in favor of some realistic alternative to it, they are potentially in conflict with Regulation section 1.482-1(f)(2)(ii)(A) (allocations to be based on actual transactions).

The existing regulations contain a number of provisions indicating that, when *identifying comparable transactions*, the Commissioner may use an uncontrolled transaction that involves similar functions as the controlled transaction, but that takes a somewhat different form.[16] In effect, these provisions expand the universe of uncontrolled comparable transactions, without changing the requirement that the uncontrolled transaction selected must have close similarity to the controlled transaction. In our view, existing regulations relate only to the selection of uncontrolled comparable transactions. In any event, they do not give the Commissioner authority to recast the *controlled transaction* in a way that is "economically equivalent" to the actual transaction in which the taxpayer engaged.

It is well established that "a taxpayer is free to adopt such organization for his affairs as he may choose," and "ha[s] the right to plan and carry out transactions in such a manner as to minimize the incidence of taxation."[17] Courts have consistently rejected attempts, whether by the Service or by taxpayers, to price controlled transactions in accordance with some alternative transaction that was not actually selected. In *Hospital Corp.*, for example, the Court said:

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[14] *Id.*

[15] *Id.* (citations omitted). The current regulations outside the context of Reg. § 1.482-7 provide only one example of the realistic alternatives concept. *See* Reg. § 1.482-4(d)(2), Example. In this so-called "Longbond" example, the Commissioner concludes that a royalty of $100 per ton for a license allowing a controlled party to use a patented manufacturing process was not an arm's length charge, because the licensor could have continued to manufacture the product itself, in which case event it could have sold the product in the relevant market to generate a profit of $250 per ton. The example does not say how (or whether) the Commissioner might use the information concerning the realistic alternative to determine the arm's length charge for the controlled transaction.

[16] *E.g.*, Reg. §§ 1.482-3(c)(3)(ii)(D) (sales agent for buy-sell distributor); 1.482-3(d)(3)(ii)(D) (purchasing agent for manufacturer); 1.482-9(d)(3)(ii)(D) (buy-sell distributor for taxpayer that performs an intermediary function).

[17] *Hospital Corp. of America v. Commissioner*, 81 T.C. 520, 583 (1983) (citing *Higgins v. Smith*, 308 U.S. 473 (1940) and *Gregory v. Helvering*, 293 U.S. 465 (1935)) (internal quotation omitted).

> Respondent's contention that LTD is a sham is based primarily on his assertion that petitioner could have negotiated and performed the contract itself. The question is not whether petitioner could have, but whether it in fact did.[18]

Similarly, in *B. Forman*, the court rejected an attempt on the part of the taxpayer to evaluate related party loans by reference to a realistic alternative (capital contributions), when there was "no doubt that the parties intended to and did treat these transactions as loans."[19] The courts have consistently rejected attempts to override controlled parties' contractual allocations of functions and risks and to evaluate transactions that the parties did not in fact, adopt.[20]

We recommend that the temporary regulations clarify that the Commissioner's existing authority to impute contractual terms based on economic substance is not expanded in this specific context.

3. Harmonization with Existing "Category of Method" and "Best Method" Rules

The existing regulations provide guidance about the sequence for analyzing controlled transactions. At the outset, one determines which of several "categories of method" (tangible property, intangible property, services, etc.) describes the controlled transaction(s).[21] Once this determination is made, coordination may be necessary among the distinct categories of method.[22] The aggregation rules are then applied. Together, the rules enable the transfer pricing analyst to perform a high-level classification of the controlled transactions. Then and only then is the best method rule applied. The best method rule takes into account the transfer pricing methods for the specific type of controlled transaction and considers the availability of data concerning uncontrolled transactions, the sufficiency of the data under the comparability criteria applicable to specific transfer pricing methods, and other factors.[23]

The temporary regulations revise former Regulation section 1.482-1(f)(2)(ii) and adopt a new structure. However, it is unclear how the new provisions will likely interact with the existing regulations. Moreover, this seems to be an instance where the regulations, in a quest to identify

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18 *Hospital Corp.*, 81 T.C. at 585-86.

19 *B. Forman Co. v. Commissioner*, 453 F.2d 1144, 1156 (2d Cir. 1972).

20 *See, e.g.*, *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1084, 1089 (2d Cir. 1991) (rejecting the Commissioner's attempt to re-characterize a manufacturing subsidiary as a contract manufacturer).

21 *See* Reg. § 1.482-1(b)(2)(ii). The regulations contain additional rules concerning selection of the "category of method" in connection with intangible development arrangements. Reg. § 1. 482-1(b)(2)(iii).

22 *E.g.*, Reg. §§ 1.482-3(f) (embedded intangibles); 1.482-7(a)(3)(iii) (other controlled transactions in connection with a cost sharing arrangement); 1.482-9(m) (coordination of controlled services rules with other provisions). In addition, "property or services" constitutes a general comparability factor that applies to all categories of method. *See* Reg. § 1.482-1(d)(3)(v).

23 Reg. § 1.482-1(c) (best method rule).

"all value," invariably will favor certain transfer methods over others. Under the circumstances, we recommend that the regulations provide additional detail on how the new rules will interact with the existing rules.

The temporary regulations imply that, when intangible property is transferred from the United States, a substantial portion of the residual income from that property should be allocated to the transferor.[24] This result apparently obtains without regard to the form of the controlled transaction, the facts surrounding the transfer, or the specific type of intangible property or other contributions at issue. The implication is that controlled transactions involving intangibles transfers should be evaluated using either a profit split method or an unspecified method that assigns most or all nonroutine returns to the U.S. transferor. In our view, this approach conflicts with the best method rule in the existing regulations and the concept that no transfer pricing method is preferred for any particular type of controlled transaction.[25]

B. The Temporary Regulations Fail to Align with Existing Rules Regarding Selection of the Best Method

Section 1.482-1T(f)(2)(1)(D) of the temporary regulations provides that it may be necessary to allocate one or more portions of the arm's length result in a way that provides the most reliable measure of the arm's length result for each allocated amount. We submit that this provision fails to address the issues that commonly arise in this area. A simplified example will illustrate our concerns in this regard.

Assume that the Commissioner, applying a "coordinated best method analysis," determines that "all value" associated with an outbound transfer, evaluated on an aggregate basis, is $300x. Assume further that the aggregate analysis uses a discounted cash flow method that takes into account traditional intangible property as well as workforce in place and other "contributions" made by the transferor. By its terms, the provision as drafted suggests that the $300x amount in the hypothetical would be allocated to the specific components of the transaction (intangible property, valuable contributions, etc.) in a way that provides the most reliable measure of each allocated amount. It is unclear on what basis (other than a profit split) aggregate value could be reliably assigned to the specific elements of the integrated transaction (intangible property, valuable contributions, etc.).[26] Presumably, the best method rule could not be applied to each specific component of the transaction, which was why the Commissioner found that an aggregate analysis would be more reliable than a separate analysis.

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[24] For example, the Preamble notes that "controlled parties evaluate economically integrated transactions involving economically integrated transactions, synergies, and interrelated value on a separate basis in a manner that results in a misapplication of the best method rule and fails to reflect the arm's length result." The clear implication is that taxpayers fail to consider items that would necessarily be included under a more robust analysis.

[25] *See* Reg. § 1.482-1(c)(1).

[26] It is unclear how goodwill and going concern value might be reliably allocated to distinct taxable and non-taxable components of the transaction, although this type of allocation is apparently required by this provision.

The temporary regulations reflect an apparent concern on the part of the Service that controlled taxpayers often assign too little value to taxable elements of the controlled transfer, and too much value to non-taxable elements. In our view, this provision imposes a new regulatory framework, but that framework provides no new analytical tools,[27] or concrete guidance on how to allocate value "in a manner that provides the most reliable measure of each allocated amount." A possible reading of this provision is that once "all value" is determined on an aggregate basis, each constituent part of the transaction is then analyzed. The goal of such an analysis would be to find a reliable way to allocate that value to specific components of the transaction. But that seems at odds with the conclusion that an aggregate analysis was more reliable in the first instance.

Because goodwill and going concern value cannot be reliably allocated to specific elements of a transaction, those items have been traditionally defined (for transfer pricing and for other tax purposes) and valued as the residual amount that remains after all other components of a transaction are identified and valued. *See* Reg. § 1.367(a)-1T(d)(5)(iii) (defining "foreign goodwill or going concern value" as the residual value of a business operation conducted outside the United States). As noted in the Preamble to the regulations under section 338, "[b]ecause of the difficulty in valuing goodwill and going concern value, it was decided to value and assign basis to other assets first, with the residual excess (i.e., the amount of gross-up basis over the amount allocated to other assets) if any, being assigned to goodwill and going concern value."[28]

The temporary regulations reverse a long-standing policy determination. Among other things, the regulations call for taxpayers and examiners to perform difficult "second-tier allocations" that require (i) an independent valuation of goodwill and going concern value and (ii) an allocation of synergies in excess of all asset values across multiple components of a transaction – an approach that Treasury in the past has expressly rejected in favor of the more reliable residual method. We note that the substantive treatment of goodwill and going concern value is currently being refined, given that the notice-and-comment process is ongoing concerning the proposed section 367 regulations. Under the circumstances, we believe that it is inappropriate and inconsistent with the notice and comment process required under the Administrative Procedure Act to adopt a valuation and allocation protocol for goodwill and going concern value before the substantive treatment of those items has been resolved.[29] Only at such time should the section 482 regulations be conformed to any such departure from the residual method, which has long applied in many different contexts under current law. At a minimum, assuming that a second-

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[27] Among other things, this provision provides no guidance on how goodwill and going concern value, likely components of the full value approach, are allocated among specific elements of the controlled transaction.

[28] T.D. 8072, 1986-1 C.B. 111 (Jan. 29, 1986).

[29] In 1986, Congress revised the section 367(d) and section 482 rules to include the commensurate with income standard for intangible property. By doing so, Congress intended that the value of related party transfers of intangibles should be taxed on the same basis, regardless of the form the transaction took. The legislative history states, in relevant part, that the "standard the payments must be commensurate with the income attributable to the intangibles applies in determining the amounts to be imputed under section 367(d) and in determining the appropriate section 482 allocation in other situations." *See* H.R. REP. NO. 99-246 at 424. The same language is also found in the 1986 "Blue Book." *See* JCS-10-87 at 1016.

tier allocation is required, practical detailed guidance would be needed concerning such an approach.

C. The Temporary Regulations Potentially Conflict with Bilateral Tax Treaties Entered into by the United States

The approach in the temporary regulations appears to conflict with the United States' obligations under its bilateral tax treaties. The arm's length principle, as interpreted by the OECD Transfer Pricing Guidelines, is incorporated in Article 7 ("Business Profits") and Article 9 ("Associated Enterprises") of the 2006 U.S. Model Income Tax Convention and in nearly every bilateral tax treaty executed by the United States. As described above, several provisions in the temporary regulations are inconsistent with the behavior of parties dealing at arm's length and consequently with the arm's length standard in the U.S. transfer pricing regulations. Accordingly, these regulations will result in double taxation and will likely make it more difficult to resolve the double tax cases that will inevitably arise.

As developed above, the term "all value" is not clearly defined, but it clearly refers to something other than the "arm's length price." As such, it is unclear whether the requirement in Regulation section 1.482-1T(f)(2)(i)(A) can be harmonized with the arm's length principle. The OECD Transfer Pricing Guidelines, while not applicable law for U.S. tax purposes, have been adopted by reference in the transfer pricing legislation of a number of other countries. The OECD Guidelines state that the "[a]pplication of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances."[30] The compensation for such transactions should reflect the functions that each associated enterprise performs, taking into account assets used and risks assumed. The OECD Guidelines do not call for a subjective determination of "all value" transferred.[31]

We have also noted that the temporary regulations seem to contemplate increased reliance on "realistic alternatives" as a basis on which to override the actual terms of the controlled transaction.[32] This arguably conflicts with the arm's length principle described in the OECD Guidelines. The OECD Guidelines note that "[a] tax administration should not disregard the actual transaction or substitute other transactions for it unless . . . the transaction viewed in its entirety lacks the commercial rationality of the arrangements between unrelated parties."[33] The

30 *See* OECD Transfer Pricing Guidelines (July 2010 ed.) ¶ 1.33.

31 *Id*. at ¶ 1.51.

32 We disagree with the analysis in Example 8, which focuses on the taxpayer's characterization of a transaction for *income tax purposes*. Historically, the Commissioner evaluated transactional alternatives available to the controlled taxpayer, *e.g.*, license vs. sell, make vs. buy, etc. This principle did not extend, however, to the taxpayer's decision to classify a transaction in a particular way for income tax purposes (*e.g.*, to make a section 351 transfer as opposed to a platform contribution transaction in connection with a cost sharing arrangement under Regulation section 1.482-7).

33 *See* OECD Transfer Pricing Guidelines (July 2010 ed.) ¶¶ 1.122–1.123. The OECD Guidelines recognize that the tax administrator can reject the terms of a controlled transaction when (1) similar terms are not observed in transactions between independent enterprises acting in a commercially reasonable manner and (2) as a practical
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OECD Guidelines also note that "restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequality of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured."[34] By requiring compensation for "all value," determined "without regard to the form or character of the transaction,"[35] the temporary regulations seem to contemplate increased restructuring of legitimate business transactions.[36]

D. The Temporary Regulations Modify the Arm's Length Standard in Several Additional Respects

1. Departure from Transactional Focus of Section 482

The existing regulations provide that, in determining the true taxable income of a controlled taxpayer, the applicable standard is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.[37] Historically, the regulations took a transactional approach to evaluating the arm's length result. As noted above, the Commissioner has authority to modify the terms of a controlled transaction if the controlled taxpayer failed to specify contractual terms or if the Commissioner determines that the controlled transaction as structured lacks economic substance.[38] Technically, the Commissioner determines the arm's length price and does not actually modify the terms of the transaction, even when the arm's length price is evaluated by reference to economic substance or taking into account realistic alternatives.[39]

These regulatory provisions are buttressed by case law that declines to sanction the use of section 482 as a means of recharacterizing a controlled taxpayer's transactions. For example, in *Eli*

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matter, the transaction's structure impeded determination of the appropriate transfer price. *Id*. at ¶ 1.65. The U.S. regulations have not contained analogous provisions.

34 *Id.* at ¶ 1.123.

35 Reg. § 1.482-1T(f)(2)(i)(A).

36 It was widely reported that, in the recent Base Erosion and Profit Shifting (BEPS) project, the United States opposed efforts by certain OECD members to give tax administrations broader latitude to reconfigure controlled transactions. If that is correct, it is hard to understand why the temporary regulations give the Commissioner broad authority to consider alternative transactions in the context of outbound intangibles transfers.

37 Reg. § 1.482-1(b)(1).

38 Reg. § 1.482-1(f)(2)(ii)(A). *See* T.D. 8552 ("Section 1.482-1(f)(2)(ii) provides that the district director ordinarily will evaluate controlled transactions based on the structure of the actual transaction, and will not treat the transaction as if it had been structured differently. The district director may, however, consider the alternatives that were available to the taxpayer in determining whether the terms of the controlled transactions would be acceptable to an uncontrolled taxpayer faced with similar alternatives. Adjustments should be made in such cases to reflect material differences between the alternative and the controlled transactions. As under the 1993 regulations, this authority to examine alternatives is *limited to the determination of an arm's length price, and does not permit the district director to treat a controlled transaction as if it actually had been structured differently*.") (Emphasis added).

39 *Id*.

Lilly, [40] the taxpayer ("Lilly"), a U.S. corporation, formed a Puerto Rican subsidiary ("LPR") to manufacture prescription drugs previously manufactured by it. LPR was formed in order to take advantage of the tax incentives for doing business in Puerto Rico under U.S. federal income tax law. Lilly transferred ownership of two valuable patents and proprietary information on the manufacturing process to LPR in exchange for stock, claiming non-recognition under section 351. LPR then sold all of its production to Lilly at prices designed to achieve a proper division of earnings between the companies.

The Service argued that Lilly would not have transferred its valuable patents and proprietary information for stock of an uncontrolled entity, even a controlling stake. The Service asserted that an unrelated transferee would have been confined to the role of a contract manufacturer, and its compensation should have been commensurate with that role. While recognizing that Congress gave the Service authority under section 482 to override non-recognition rules -- at least where business purpose was lacking or income was artificially separated from productive assets – the Seventh Circuit upheld the form of the transaction, including the application of section 351(a), and proceeded to analyze the transfer prices of the intercompany sales.[41] The court also refused to follow the Tax Court's opinion to the extent that it imputed a royalty arrangement on the initial exchange.[42]

2. Projections and Unspecified Transfer Pricing Methods Favored

By requiring taxpayers to take account of "all value," the temporary regulations imply an increased use of profit based methods and projections, as opposed to methods that use data from uncontrolled transactions. Indeed, Example 5 of the temporary regulations shows the Commissioner rejecting a valuation based on comparable uncontrolled licenses in favor of an aggregated discounted cash flow analysis, based on internal projections.[43]

The existing regulations require transfer pricing methods to be selected and applied in a manner consistent with arm's length behavior, to the extent possible. "Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer."[44] "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."[45] The arm's length standard has been included in the section 482 regulations, and their predecessors, since 1935. The bilateral tax treaties of the United States adopt the corresponding arm's length principle for transfer pricing matters. The arm's length

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40 *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855 (7th Cir. 1988).

41 *Id. See also G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987); *Baldwin-Lima-Hamilton v. Commissioner*, 435 F.2d 182 (7th Cir. 1970).

42 *Id.*

43 Reg. § 1.482-1T(f)(2)(i)(E), Ex. (5).

44 Reg. § 1.482-1(a)(1).

45 Reg. § 1.482-1(b)(1).

standard holds controlled taxpayers to the standard of behavior observed in the marketplace. This is in fact the preferred approach under the current regulations.[46]

The courts have expressed a preference for transfer pricing methods that rely on uncontrolled comparable transactions, as opposed to theoretical economic models. For example, the Second Circuit has concluded that an uncontrolled comparable that is "sufficiently similar" to the controlled transaction provides a reliable basis for determining the arm's length price of the controlled transaction.[47]

E. Application of Multiple Transfer Pricing Methods to the Same Transaction or Group of Transactions

In applying the best method rule, controlled taxpayers are generally required to apply only one transfer pricing method (the best method).[48] The section 482 regulations address situations in which two or more transfer pricing methods produce inconsistent results, or different applications of the same method produce inconsistent results[49] Importantly, the regulations stop short of specifically directing taxpayers (or the Service) to apply more than one transfer pricing method as a way of identifying the best method. As a practical matter, such a requirement would substantially increase the cost and complexity of evaluating the arm's length result. Selecting the best method in a particular case should turn on the availability, comparability and quality of data concerning uncontrolled transactions, and the reliability of any adjustments made to such data. It is not apparent, however, that this result obtains under the temporary regulations.

The Preamble suggests that some controlled taxpayers' valuations are incomplete – because they purportedly ignore "economically integrated contributions, synergies, and interrelated value."[50] In response, the temporary regulations authorize the Commissioner to apply specified or unspecified methods for purposes of explicitly incorporating synergies or other items of value that may have been discounted or not fully taken into account. We recommend that the final regulations clarify that, for their part, taxpayers are not required to apply multiple valuations or transfer pricing methods, and that all determinations of value remain subject to the best method rule. Most importantly, we recommend that the regulations not require the application of

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46 Reg. § 1.482-1(e)(1) (emphasis added).

47 *United States Steel Co. v. Commissioner*, 617 F.2d 942 (2d Cir. 1980) (rejecting notion that evaluating comparability contemplates a "crippling degree of economic sophistication").

48 Reg. § 1.482-1(c)(1) ("An arm's length result may be established under any method without establishing the reliability of another method, but if another method subsequently is shown to produce a more reliable measure of an arms' length result, such other method must be used.") The OECD Guidelines take a similar approach. "The arm's length principle does not require the application of more than one [transfer pricing] method for a given transaction (or set of transactions that are appropriately aggregated…) and in fact undue reliance on such an approach could create a significant burden for taxpayers." *See* OECD Transfer Pricing Guidelines (July 2010 ed.), ¶ 2.11.

49 *See* Reg. §§ 1.482-1(c)(1), -1(c)(2)(iii).

50 T.D. 9738, 2015-40 IRB 453 at 5.

multiple transfer pricing methods or selection of the method that yields the highest valuation, on the grounds that such method captures "all value" associated with the controlled transactions."[51]

F. Potential for Mis-Application of Synergy Concept

The Preamble refers to synergies that may exist among multiple items of intangible property, contributions, or other assets or services that form part of a single transfer or group of transfers. In fact, the identification and taxation of synergies appears to be a primary motivation for the regulatory guidance. The implicit assumption is that if transactions are analyzed on an aggregate basis, it is more likely that synergies will be taken into account.[52] We agree that synergies exist in some cases, and, in general, we accept the notion that, if the objective is to tax such synergies, that objective may be more readily accomplished through an aggregate analysis.[53] At the same time, we have concerns that this approach may lend itself to subjective and even unprincipled applications.

Synergies are frequently touted to exist in ongoing business operations and business combinations, yet in reality, they are often difficult to identify and harder still to quantify. We are concerned that, in the transfer pricing context, synergies could become a distraction from the matter at hand. Without more detailed guidance (*e.g.*, definition, origin, source, life, conditions and limits of existence, etc.), incorporating synergies into the best method analysis risks developing a means of "value creation." That is, instead of seeking the method that produces the most reliable result, in view of the specific facts and circumstances, examiners might seek the method that produces the highest result, given the presumed impact of synergies.

In addition, the lack of explicit guidance regarding synergies could result in all synergistic value being attributed to the transferor. This would conflict with the practical observation that synergies, almost by definition, result from a combination of contributions: skillful management and emerging technology, innovative products and savvy marketing, low-cost production and global supply chain; eliminating operational redundancy, etc.

Finally, given that examinations by the Service necessarily occur after the fact, there is a concern that any/all additional future value—i.e., amounts in excess of the initial, projected value—will be incorrectly ascribed to synergies that existed prior to the valuation date. In short, examiners might fail to take account of the lifecycle of the synergies, or the possibility that some synergies

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51 As noted above, Treasury and the Service may face similar arguments in the context of *inbound* transfers of intangible property. These comments do not address concerns that may arise in that area.

52 *E.g.*, T.D. 9738, 2015-40 IRB 453 (The Preamble states: "[I]f consideration of the facts and circumstances reveals synergies among interrelated transactions, an aggregate evaluation under section 482 may provide a more reliable measure of an arm's length result than a separate evaluation of the transactions."). *See also* Reg. § 1.482-1T(f)(2)(i), Ex. (5), (9).

53 By comparison, the Tax Court in *VERITAS* rejected the Service's contentions that an aggregate analysis was required under the then-applicable section 482 regulations due to the existence of "synergies that imbue the whole with greater value than each asset standing alone." *VERITAS Software Corp. v. Commissioner*, 133 T.C. 297, 320 (2009).

may have been generated in the intervening period, when the analytical focus should instead be on the date on which the transfer took place.

Overall, we are concerned that the high degree of emphasis on synergies, coupled with the lack of definition and more detailed guidance, creates conditions for the overuse, and potential abuse, of the concept in evaluating controlled transactions.

G. Preamble Statements Concerning Abuse and Tax Avoidance

The proposed regulations under section 367(a) and (d), and the related temporary regulations in T.D. 9738, reflect the view that taxpayers abused the prior regulatory framework in order to minimize their U.S. tax liability, and that these perceived abuses warrant immediate changes to the regulations. Treasury and the Service have objected to the notion that outbound transfers may result in certain items of value exiting the U.S. tax net without compensation. Treasury and the Service take to this view despite the fact that the regulations[54] historically required compensation only with respect to intangible property, using a definition that tracks almost *verbatim* the definition in section 936(h)(3)(B). The regulations do not require compensation for every conceivable item of value relevant under a full "business enterprise" valuation.

The predicate for these recent actions is explained most clearly in the Preamble to the proposed regulations under section 367, which is beyond the scope of the present comments. There, Treasury and the Service rejected the legislative history that supports the foreign goodwill and going concern exception, based on the view that "taxpayer positions and interpretations . . . are inconsistent with the expectation, expressed in the legislative history, that the transfer of foreign goodwill or going concern value developed by a foreign branch to a foreign corporation was unlikely to result in abuse of the U.S. tax system."[55] In short, abuses resulted because taxpayers undervalued compensable intangibles and inflated residual value, which they classified as nontaxable foreign goodwill and going concern value.

The temporary section 482 regulations, while not as explicit concerning taxpayer abuses, propose three distinct "fixes": (1) require aggregate valuation of transfers when synergies are present;[56] (2) take into account "all value" of separate transactions;[57] and (3) require full valuation and subsequent allocation of value among multiple transactions governed by different Code sections (or different regulations).[58] Collectively, these changes mandate a business enterprise valuation in almost all cases – an approach that which, until now, was not required.

54 Reg. § 1.482-4(b).

55 REG 139483-13, I.R.B. 2015-40 (Preamble). Similarly, an example in the temporary regulations reinforces the notion that compensation must be provided for every single item in a transfer. *See* Reg. § 1.482-1T(f)(2)(i)(E), Example 7 (taxpayer's classification of a specific item in Portion 1 (taxable) or Portion 2 (non-taxable or non-transferable) is irrelevant).

56 Reg. § 1.482-1T(f)(2)(i)(B).

57 Reg. § 1.482-1T(f)(2)(ii)(C).

58 Reg. § 1.482-1T(f)(2)(ii)(D).

In our view, taxpayers did not engage in abuse by virtue of the fact that they applied a residual method, which refrains from allocating goodwill, going concern value, synergy value, or workforce in place to other items. Arguably, taxpayers correctly limited valuations to items of intangible property within the meaning of section 936(h)(3)(B), as opposed to "all value" of the business enterprise. This approach was based on the plain meaning and history of the existing regulations, as recently confirmed by the Tax Court in *VERITAS*. [59] That decision confirmed that items of intangible property subject to compensation under section 482 are limited to items of intangible property defined in section 936(h)(3)(B), which has not been considered to include goodwill and going concern value.[60]

III. CONCLUSION

On behalf of the Transfer Pricing Committee of the ABA Taxation Section, we appreciate the opportunity to submit these comments concerning section 482 issues in connection with T.D. 9738. We would be glad to discuss any of these comments in more detail, at your convenience.

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59 *VERITAS Software Corp. v. Commissioner*, 133 T.C. 297 (2009).

60 The Service implicitly acknowledged this in the notice of proposed rulemaking for the 1993 temporary and proposed 482 regulations, when it sought comments on "whether the definition of intangible property incorporated in § 1.482-4T(b) should be *expanded* to include items not normally considered to be items of intellectual property, such as work force in place, goodwill or going concern value." 1993-1 C.B. 825, 827 (emphasis added). In addition, in defining "property that does not give rise to income," Regulation section 1.954-2(e)(3)(iv) differentiates between intangible property defined in section 936(h)(3)(B) on the one hand and goodwill and going concern value on the other hand. Similarly, in Regulation section 1.861-9T(h)(1)(ii), goodwill or going concern value is listed separately from "intangible property as defined in section 936(h)(3)(B)."