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Companies Attempt to Ensure Pricing Process Meets SOX Requirements
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In Practice

A Market-Based Approach for Tangible Property Transfer Pricing

BY RICHARD P. ROZEK, GEORGE G. KORENKO, AND EMILY R. BISHKO*

In several recent high profile tax controversies,[1] tax authorities have proposed millions or even billions of dollars in proposed transfer pricing adjustments, interest, and/or penalties for companies in the pharmaceutical and other industries. While these disputes are being resolved in court, multinational companies should examine their transfer pricing practices to ensure the methods employed and associated supporting documentation are consistent with applicable tax guidelines. Identifying the most appropriate data and methods to apply reduces the likelihood of controversies with tax authorities and associated costly defenses, penalties, and/or double taxation. This article focuses on how to determine an appropriate price for tangible property transferred to marketing entities that bear costs and risks.[2]

Given the methods described in the Internal Revenue Service's transfer pricing regulations,[3] taxpayers should consider applying the resale price method (RPM) in cases in which there are agreements with third parties to perform marketing activities[4] and the taxpayer has prepared reliable contemporaneous financial analyses for management to review. This approach allows the taxpayer to measure the value of its controlled marketing function in terms of market-based transactions.

This article describes a hypothetical intercompany transaction involving tangible property in the form of a finished, packaged pharmaceutical product sold in the United States. Although the example involves the pharmaceutical industry, the market-based approach described applies to other industries as well. Next, the article describes the relevant Section 482 regulations and data that are often available for determining the arm's-length compensation due the hypothetical U.S. marketing entity. Finally, the authors provide a stylized example of the article's approach.

Structure of the Controlled Transaction

To illustrate the issues that multinational companies often face, consider the pharmaceutical company, MultiPharma, which performs research and development for new products in Germany, manufactures and finishes products in Italy, and markets and distributes pharmaceutical products through numerous affiliates throughout the world. *See Figure 1.* The various transfers of intangible property from the R&D entity to the manufacturing entity and finished product from the manufacturing entity to the marketing entities are likely to attract attention from tax authorities. The controlled transaction is the transfer of a finished, packaged product from MultiPharma's manufacturing entity to its U.S. marketing entity.

For this transaction, the question is how to determine an arm's-length gross profit margin for MultiPharma's U.S. marketing entity that takes into account the marketing and distribution functions performed by the U.S. affiliate in connection with the pharmaceutical product, Miracle Cure.[5]

Assessing the Data Available

The hypothetical controlled transaction involves MultiPharma's U.S. marketing entity purchasing the finished, packaged pharmaceutical product, Miracle Cure, from an affiliate and conducting marketing and distribution activities. Possible data sources for measuring the price to charge the marketing entity include:

- agreements that MultiPharma negotiated with third parties for U.S. marketing rights to pharmaceutical products;

[1] For example, *GlaxosSmithKline Holdings (Americas) Inc. v. Comr.*, No. 5750-04, *Volatility Opportunity Fund LP v. Comr.*, No. 9868-04, *DHL Corp. v. Comr.*, 9th Circuit, Nos. 99-071580, 99-71592, 99-71675, and 00-70008, dated April 11, 2002, and *United Parcel Service of America Inc. v. Comr.*, Nos. 15993-95, 7044-99, and 9674-99. (12 *Transfer Pricing Report* 1106, 4/14/04).

[2] The article does not address returns for limited-risk distributors or commissionaire arrangements.

[3] IRS final Section 482 regulations (TD 8552) for intercompany transfer pricing, issued July 1, 1994.

[4] In addition to marketing agreements with third parties, the authors suggest reviewing co-promotion or co-marketing agreements.

[5] The marketing entity's gross profit margin is equal to the revenue it receives from selling the product, less the price it pays the manufacturing entity for the finished, packaged pharmaceutical product. Price is expressed as a percent of net sales.

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- other pharmaceutical marketing agreements from public sources;
- financial information on pharmaceutical companies performing marketing functions in the United States; and
- contracts between companies for detailing pharmaceutical products.[6]

Based on the authors' experiences, a taxpayer's agreements with third parties for performing marketing functions and associated documents including commercial or financial analyses of the transaction generally constitute the most reliable set of data for determining an arm's-length result. If such market-based agreements exist, they reflect the terms of transfer that the taxpayer negotiated with unrelated parties during the ordinary course of business. These agreements contain detailed information on the functions performed and risks borne by each party. While some of the terms in the agreements may not be identical to the controlled transaction, they often satisfy the standard for acceptable comparable transactions.[7]

In addition to the agreement itself, companies often prepare financial analyses of the proposed transaction to present to management when deciding whether to enter into the transaction.[8] These analyses reflect the expected revenues and costs associated with the marketing activities based on the specific circumstances of the transactions when the agreements were negotiated. The Section 482 regulations suggest that a transfer pricing analysis should be based on such data where available.[9]

In contrast, three alternative sources of data that may be available are less comprehensive. First, a limited number of marketing agreements for pharmaceutical products between two independent companies are available in the public domain. A small pharmaceutical company may attach such an agreement to its corporate financial statements or regulatory filings if the agreement is material to the company. However, relatively few of these types of agreements are available, and they may not be representative of transactions in the industry. Generally, other pharmaceutical companies only reveal publicly limited information on the specific terms of agreements and often do not release internal analyses of the financial assessment of the agreement.

Second, there may be independent U.S. pharmaceutical marketing companies that perform functions comparable to the taxpayer in the controlled transaction. In our experience, public companies that perform marketing and distribution of pharmaceutical products typically report financial data on their overall activities rather than on revenues and costs of specific projects. Typically, such aggregate data reflect results from performing a variety of functions and may not be useful for assessing the returns for specific marketing functions.

Third, contract sales organizations (CSOs) may be engaged in providing detailing services on a contract basis for particular products. The contracts typically specify a cost per detail or cost per physician visit. This detailing function is only part of the overall marketing and distribution efforts of the taxpayer in the controlled transaction. In addition a CSO does not bear the same risks and may not have the same established relationships and reputation within the medical community as a multinational pharmaceutical company.

Considering these four types of data, a taxpayer's marketing agreements with third parties and the associated internal financial analyses prepared for management often provide the most reliable information for analyzing what would have been negotiated if the manufacturing and marketing affiliates in the intercompany transaction were independent companies. The taxpayer must then evaluate the methods in the Section 482 regulations to determine the best method to apply with these data to the controlled transaction.

Transfer Pricing Methods

Resale Price Method

The resale price method (RPM) "evaluates whether the amount charged in a controlled transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions."[10] RPM is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the property by physically altering the goods before resale.[11] Under the RPM, comparability is particularly dependent on the functional similarity of the controlled and uncontrolled parties. Functional comparability is measured in terms of the value of the functions performed, the contractual terms, and the risks borne.[12]

In applying the RPM, the Section 482 regulations advocate using arm's-length transactions of the controlled reseller. "If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers."[13] The taxpayer's marketing agreements with third parties represent potentially comparable transactions since the functions performed by the U.S. marketing entity in the uncontrolled and controlled transactions are often similar. The agreements also satisfy the requirement in the Section 482 regula-

[6] A "detail" is a personal contact by a pharmaceutical sales representative with a medical professional who has prescribing authority or has influence over the pharmaceutical treatment of patients. Companies that provide detailing on a contract basis are referred to as contract sales organizations (CSOs).

[7] "In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's-length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results." *See* Regs. §1.482-1(d)(2).

[8] In some cases, draft agreements may also be useful for a transfer pricing study.

[9] Regs. §1.482-1(c)(2) states "data based on results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length." Furthermore, fewer adjustments are necessary when the taxpayer is a party to the agreements in both the controlled and uncontrolled transactions.

[10] Regs. §1.482-3(c)(1).

[11] Regs. §1.482-3(c)(1).

[12] Regs. §1.482-3(c)(3)(ii)(A).

[13] Regs. §1.482-3(c)(3)(ii)(A).

tions that "the controlled and uncontrolled transactions would involve the distribution of products of the same general type;"[14] that is, prescription pharmaceutical products in this article's example.

Thus, when a taxpayer has entered into agreements with third parties for U.S. marketing rights and prepared associated financial analyses, the RPM often emerges as the best method for determining the arm's-length purchase price for a finished, packaged pharmaceutical product in the controlled transaction. The similarity of the functions performed, contractual terms, risks borne, and the accuracy and reliability of the data support using RPM.[15]

Other Methods

Comparable Uncontrolled Price Method

The comparable uncontrolled price (CUP) method is preferable to other methods only when uncontrolled transactions do not differ from the controlled transaction analyzed or when it is possible to adjust accurately for dissimilarities.[16] A CUP is infrequently available from a taxpayer's marketing agreements or public data sources. The marketing agreements may not meet the comparability standards required for a CUP, and adjustments to render the products comparable under the CUP method may not be possible.[17] Public data on marketing activities by unrelated companies do not provide sufficient similarity to the controlled transaction to apply the CUP method. In addition, a company's arrangements with CSOs do not constitute a CUP since they are not functionally comparable and the CSOs do not purchase the product.

Cost Plus Method

The cost plus method, like the RPM, is appropriate when the taxpayer can identify comparables with close functional similarity. However, the cost plus method often applies in instances when the functions performed by the controlled party are manufacturing in nature.[18] The functions performed by a marketing entity involve activities related to the resale of a finished, packaged pharmaceutical product. The cost plus method most likely is not the best method to determine the arm's-length transfer price for marketing and distributing such a product.

Comparable Profits Method

Under the comparable profits methods (CPM), an arm's-length price is set by reference to third-party operating profits. CPM is less sensitive than RPM to product differences. "[H]owever, the reliability of profitability measures based on operating profit may be adversely affected by factors that have less effect on results under the comparable uncontrolled price, resale price, and cost plus methods."[19] In addition, the Section 482 regulations state, "[t]he degree of functional comparability required to obtain a reliable result under the comparable profits method . . . is generally less than that required under the resale price or cost plus methods."[20] Given the degree of functional comparability that can be established between the uncontrolled and controlled marketing transactions, an RPM analysis using the taxpayer's agreements with third parties provides a more reliable result than a CPM analysis based on financial data for publicly traded companies. Also, as the standard of comparability required under CPM is less stringent than those for the CUP method and RPM, CPM is generally used only as a method of last resort.[21]

Profit Split Method

Taxpayers that apply the profit split method often rely either partially or entirely on the controlled company's data and transactions. A taxpayer's marketing agreements with third parties and associated financial analyses do not include sufficient data on the profit its marketing partner expects to earn from the transaction. These data are sensitive business information that parties do not exchange in negotiation or reveal publicly. Without information from one party to a transaction, the profit split method has limited use for establishing an arm's-length transfer price for a finished, packaged pharmaceutical product.

Unspecified Method

An unspecified method also may be applied if it provides a more reliable arm's-length result than the specified methods. It is conceivable that if the taxpayer's marketing agreements with third parties and associated financial analyses are available, an appropriate unspecified method may exist. However, that issue is not addressed in this article, which focuses on the application of the RPM to the available data on marketing agreements.

Applying the Resale Price Method

Data

Assume the taxpayer, MultiPharma, negotiated four marketing agreements with the following third parties and prepared associated financial analyses: Numb Inc., Breathe Easy Co., Love Inc., and Big Knee Co. for the pharmaceutical products Pain Away, Cold Cure, Heart Plus, and Swell Down, respectively. *See* Table 1. For each agreement, the gross profit margin is provided. An effective purchase price based on a detailed analysis of the agreement and associated financial analysis also is provided. The effective purchase price in each case is equal to 100 percent minus the gross profit margin.

These agreements and analyses are the most reliable data available for determining the arm's-length pur-

[14] Regs. §1.482-3(c)(3)(ii)(B).

[15] Where differences exist between the third-party agreements and the controlled transaction, financial analyses for the uncontrolled transactions must be adjusted to reflect compensation the companies would have negotiated if the marketing entity performed the same functions and bore the same risks as the U.S. taxpayer.

[16] Preamble to Regs. §1.482.

[17] Regs. §1.482-3(b)(2)(ii)(A).

[18] Regs. §1.482-3(d)(1).

[19] Regs. §1.482-5(c)(2)(iii) offers examples of such factors affecting operating profit: varying cost structures (age of plant and equipment), differences in business experience (start-up or mature), or differences in management efficiency (expanding or contracting sales or executive compensation over time).

[20] Regs. §1.482-5(c)(2)(ii).

[21] Preamble to Regs. §1.482.

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chase price for the transfer of Miracle Cure from the manufacturing entity to the U.S. marketing entity. Given these data, RPM is the best method to apply in this case. These data provide sufficient information to determine the expected return (*i.e.*, gross profit margin) for the U.S. marketing entity for the functions performed and risks borne. The financial data also provide information required to make specific adjustments to improve the comparability of the uncontrolled transactions to the transfer of Miracle Cure.

Analysis and Results

The RPM is applied by analyzing the uncontrolled transactions to determine the nature and scope of functions performed by the marketing entity in each case and whether adjustments to the financial analyses are necessary to make them more comparable to the transfer of Miracle Cure. The Section 482 regulations require that the taxpayer give consideration to factors relating to the comparability of the uncontrolled marketing agreements and the marketing of the finished, packaged pharmaceutical product "that could affect prices or profits in arm's-length dealings."[22] In broad terms, these potentially relevant factors include:

- functions performed;
- contractual terms;
- risks;
- economic conditions;
- property and services; and
- financial and accounting comparability issues. [23]

The criteria for making adjustments may include:

- the particular difference between the controlled and uncontrolled transactions and whether the effect of any such difference has a material impact on the arm's-length result; and
- whether this impact is subject to accurate, quantifiable adjustments.[24]

Using potentially comparable transactions that relate to arm's-length transfers occurring in the same general time period within the United States reduces the need for adjustments. These agreements and the controlled transaction occur at the same level of the vertical chain,[25] and the parties face similar economic, regulatory, and market risks. Therefore, adjustments based on such factors are not necessary. Similarly, adjustments associated with currency exchange risk are not necessary since the controlled and uncontrolled transactions occur in U.S. dollars.

As stated in the Section 482 regulations, "[a] reseller's gross profit provides compensation for the performance of resale functions related to the product or products under review including an operating profit in return for the reseller's investment of capital and the assumption of risks."[26] Consequently, "consideration of operating expenses associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses."[27]

In the controlled transaction for Miracle Cure, assume MultiPharma's U.S. marketing entity performs the following functions:

- determines the marketing strategy;
- implements the strategy (*e.g.*, detailing the product to physicians, placing advertising in medical journals, arranging symposia, and using direct-to-consumer advertising);
- conducts post-approval R&D;
- develops its own trademark; and
- distributes the product.

In the uncontrolled transactions, the functions MultiPharma performs and the risks it assumes may be similar, but not identical to the controlled transaction. For example, in some of the uncontrolled transactions, MultiPharma may not own the trademark rights or perform distribution functions. In addition, MultiPharma may be required to contribute to pre-approval R&D, which is a function its U.S. marketing entity does not perform for Miracle Cure. Any material difference requires an adjustment.[28]

Using MultiPharma's financial analyses of each of the four agreements and making necessary adjustments, the marketing entity's adjusted gross profit margin over the life of each of the four agreements is determined by dividing the net present value of adjusted gross profits by the net present value of sales. The result is next subtracted from 100 percent to derive the adjusted purchase price. For example, *see* Table 2 for the calculation of the adjusted gross profit margin and adjusted purchase price for MultiPharma's agreement with Numb Inc. for the product Pain Away. Similar analyses would be prepared for the marketing agreements involving the products Cold Cure, Heart Plus, and Swell Down.[29]

In this article's example, the unadjusted gross profit margins for the four agreements are 49, 52, 45, and 51 percent, respectively. After adjustments, the gross profit margins are 41, 48, 44, and 58 percent, respectively. *See* Table 3. The adjusted gross profit margin may be higher or lower than the gross profit margin derived from the agreement depending on the nature and magnitude of the adjustments. For MultiPharma's agreements, the gross profit margins ranged from 45 percent to 52 percent of sales, whereas the adjusted gross profit margins range from 41 percent to 58 percent of sales.

Within the range of adjusted gross profit margins, a single gross profit margin is derived to apply to the intercompany transfer of Miracle Cure. For example, one may select a measure of the central tendency (*e.g.*,

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[22] Regs. §1.482-1(d)(1).

[23] A general overview of these factors is in Regs. §1.482-1(d), with specific issues related to RPM in Regs. §1.482-3(c)(3).

[24] "Adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this section, a material difference is one that would materially affect the measure of an arm's length result under the method being applied." Regs. §1.482-1(d)(2),

[25] They are transactions in which a company's U.S. marketing resources are retained to market a specific product.

[26] Regs. §1.482-3(c)(3)(ii)(A).

[27] Regs. §1.482-3(c)(3)(ii)(C).

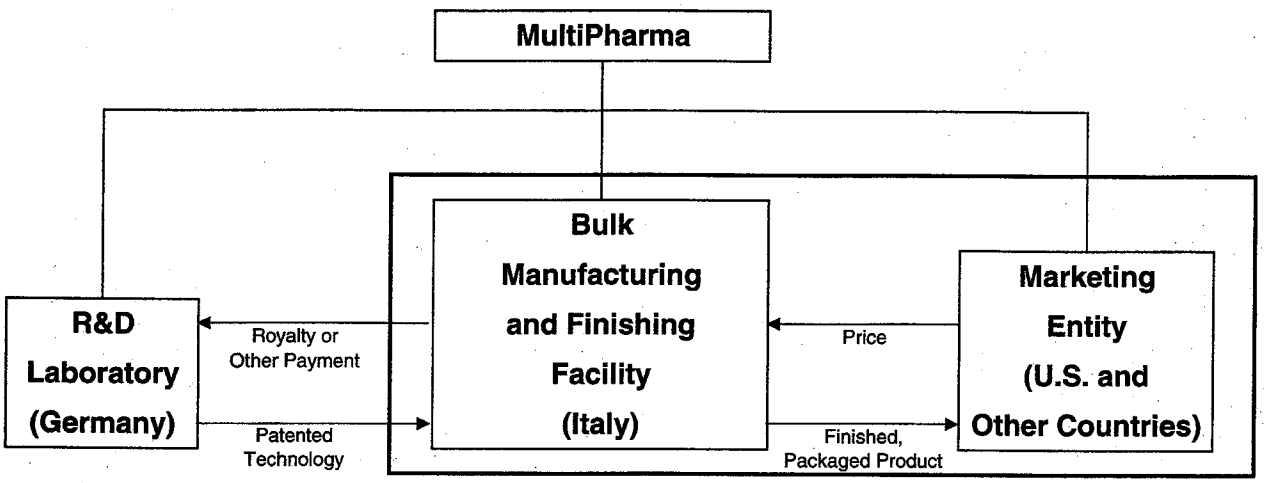
[28] This articles does not address the methodologies for making adjustments in the present analysis. The authors merely acknowledge that it may be necessary to make adjustments.

[29] To facilitate comparison of marketing agreements, some of the financial analyses prepared for management review may have to be reformulated to reflect a consistent set of assumptions (*e.g.*, discount rate, specific costs measured, and time period for forecasts) across all agreements.

Figure 1

STRUCTURE OF MULTIPHARMA

A HYPOTHETICAL RESEARCH-BASED PHARMACEUTICAL COMPANY



mean or median) or the gross profit margin from a specific comparable agreement that best matches the Miracle Cure transaction on a set of relevant dimensions. Suppose the median of the entire range of adjusted gross profit margins equals 46 percent. MultiPharma's U.S. marketing entity will retain a gross profit margin of 46 percent and will pay the manufacturing entity a price of 54 percent of sales. The gross profit margin that the U.S. marketing entity realizes reflects the value of its own marketing functions performed for third parties in the United States for similar products, adjusted for any material differences in functions performed or risks borne.

Conclusion

The risk exists for companies performing R&D, manufacturing, and marketing functions in separate countries that the IRS or other tax authorities will scrutinize their transfer pricing policies. These taxpayers should examine their transfer pricing programs to ensure that the methodologies employed and supporting documentation are consistent with applicable guidelines. Identifying appropriate data and methods to apply is a crucial factor in reducing the risk of controversies with tax authorities and associated costly defenses, penalties, and double taxation.

To address the transfer of tangible property from a manufacturing entity in one country to an affiliated marketing entity in another country, the authors suggest examining whether the taxpayer has negotiated marketing agreements with third parties. If such agreements and supporting financial analyses exist, these data are often the most reliable data available for a transfer pricing study. They measure the value of the marketing function based on the taxpayer's own market-based transactions. Using these data and applying RPM as specified in the Section 482 regulations is often an appropriate method for determining an arm's-length transfer price.

Table 1: Gross Profit Margins and Effective Purchase Prices Derived from MultiPharma's Marketing Agreements With Third Parties

Product	Third-Party Co-Promoter	Gross Profit Margin	Effective Purchase Price
		(Percent)	(Percent) 100%-(3)
(1)	(2)	(3)	(4)
Pain Away	Numb Inc.	49%	51%
Cold Cure	Breathe Easy Co.	52	48
Heart Plus	Love Inc.	45	55
Swell Down	Big Knee Co.	51	48

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Table 2: Adjusted Gross Profit Margin and Adjusted Price in The MultiPharma/Numb Inc. Agreement for Pain Away

Year	Multi-Pharma Forecasted Sales	Multi-Pharma Forecasted Gross Profits	Adjustment for Distribution	Adjustment for Trademark	Adjustment for Pre-Approval R&D	Milestone Payment	Multi-Pharma Adjusted Gross Profits	Discount Factor	NPV of Sales	NPV of Adjusted Gross Profits
	2000 — 2011									
	($ Millions)	($ Millions)	($ Millions)	($ Millions) (1)x5%	($ Millions) (1)x3%	($ Millions)	($ Millions) (2)+(3)-(4)-(5)-(6)	@10%	($ Millions) (1)x(8)	($ Millions) (7)x(8)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
2000	$45	$20	$0.22	$2.25	$1.35	$250	$(233.38)	1.0000	$45	$(233)
2001	120	60	0.57	6.00	3.60	-	50.97	0.9091	109	46
2002	185	105	0.91	9.25	5.55	-	91.11	0.8264	153	75
2003	230	145	1.13	11.50	6.90	-	127.73	0.7513	173	96
2004	260	170	1.27	13.00	7.80	-	150.47	0.6830	178	103
2005	270	180	1.30	13.50	8.10	-	159.70	0.6209	168	99
2006	280	185	1.35	14.00	8.40	-	163.95	0.5645	158	93
2007	285	195	1.38	14.25	8.55	-	173.58	0.5132	146	89
2008	290	200	1.42	14.50	8.70	-	178.22	0.4665	135	83
2009	295	205	1.45	14.75	8.85	-	182.85	0.4241	125	78
2010	300	210	1.47	15.00	9.00	-	187.47	0.3855	116	72
2011	305	215	1.50	15.25	9.15	-	192.10	0.3505	107	67
Total									$ 1,613	$ 668
							Adjusted Gross Profit Margin [Total (10)/Total (9)]:			41 %
							Adjusted Purchase Price (100% - Adjusted Gross Profit Margin):			59 %

( ) negative
– not applicable

Table 3: Adjusted Gross Profit Margins and Effective Purchase Prices from MultiPharma's Marketing Agreements with Third Parties

Product	Third-Party Co-Promoter	Derived from Agreement		Adjusted for Comparability	
		Gross Profit Margin	Effective Purchase Price	Gross Profit Margin	Effective Purchase Price
		(Percent)	(Percent) 100%-(3)	(Percent)	(Percent) 100%-(5)
(1)	(2)	(3)	(4)	(5)	(6)
Pain Away	Numb Inc.	49%	51%	41%	59%
Cold Cure	Breathe Easy Co.	52	48	48	52
Heart Plus	Love Inc.	45	55	44	56
Swell Down	Big Knee Co.	51	49	58	42