

Contents

1	Introduction	1
 Part I Economic and Accounting Rates and Concepts Should Not be Conflated		
2	Economic vs. Accounting Profit Rates	7
3	Overview and Critique of Existing Transfer Pricing Methods	11
3.1	Comparable Profits Method and TNMM	11
3.1.1	Description of CPM and TNMM	12
3.1.2	Circumstances when CPM and TNMM Are Applied	14
3.1.3	Underlying Economic Rationale	14
3.1.4	Critique of Economic Reasoning	15
3.1.5	Summary and Practical Implications	17
3.2	Resale Price and Cost Plus Methods	17
3.2.1	Circumstances when Resale Price and Cost Plus Methods Apply	18
3.2.2	Description of Resale Price and Cost Plus Methods	19
3.2.3	Underlying Economic Rationale	19
3.2.4	Critique of Economic Reasoning	20
3.2.5	Summary and Practical Implications	21
3.3	Comparable Uncontrolled Price Method	22
3.3.1	Description of Comparable Uncontrolled Price Method ...	22
3.3.2	Underlying Economic Rationale	23
3.3.3	Critique of Economic Reasoning	23
3.3.4	Summary and Practical Implications	26
3.4	Services Cost Method	26
3.4.1	Description of Services Cost Method	27
3.4.2	Rationale for Services Cost Method	28
3.5	Profit Split Methods	29
3.5.1	Residual Profit Split Method	29
3.5.2	Comparable Profit Split Method	31

3.5.3	Summary and Practical Implications	32
3.6	Proposed Cost-Sharing Regulations and Coordinated Issue Paper	32
3.6.1	Income Method	35
3.6.2	Acquisition Price Method	36
3.6.3	Market Capitalization Method	36
3.6.4	Critique	37
3.7	Global Dealing Regulations and Notice 94–40	41
3.7.1	Circumstances in Which the Proposed Global Dealing Regulations and Notice 94–40 Apply	41
3.7.2	Description of Notice 94–40 and Proposed Global Dealing Regulations	43
3.7.3	Underlying Economic Rationale	45
3.7.4	Critique of Formulary Method	45
3.7.5	Summary and Practical Implications	48

Part II Alternative and Supplementary Approaches to Transfer Pricing

4	Some Alternative Approaches to Transfer Pricing	51
4.1	Modified Comparable Uncontrolled Price Method	53
4.2	Numerical Standards	54
4.3	Required Return on Debt and Equity Capital	55
4.3.1	Required Return on Equity	56
4.3.2	Cost of Debt	60
4.3.3	Non-Cash Charges and Investment	61
4.3.4	Data Requirements	61
4.3.5	Summary	61
4.4	Joint Venture-Based Profit Split	62
4.5	Financial or Tangible Asset-Based Profit Split	63
4.6	Franchise Model	63
4.7	Summary	64

Part III Case Studies

5	Intercompany Sale of Diamonds	67
5.1	Summary of Key Facts	68
5.1.1	Historical Dominance of De Beers	68
5.1.2	The Decline of De Beers' Role and the Emergence of Parallel Primary Markets	69
5.1.3	Producers' and Sightholders' Branding and Design Development Initiatives	72
5.1.4	Pricing Dynamics: Primary, Secondary and Retail Markets	75
5.1.5	Functional Analysis of FP, IS and USS	77
5.2	Transfer Pricing Issues	79

5.3	Analysis Under Existing Regime	79
5.3.1	FP's Intercompany Sales of Rough Stones to IS	80
5.3.2	IS' Sales of Generic Polished Stones to USS	81
5.3.3	IS' Pricing of Proprietary Polished Stones Sold to USS	85
5.4	Analysis Under Alternative Regime	85
5.4.1	FP's Intercompany Sales of Rough Stones to IS	85
5.4.2	IS' Sales of Non-Proprietary Polished Stones to USS	86
5.5	Comparison	88
6	Intercompany Sale of Medical Devices	89
6.1	Summary of Key Facts	89
6.1.1	Business Unit A: In-Hospital Monitoring Systems	90
6.1.2	Business Unit B: Outpatient Monitoring Devices	91
6.2	Transfer Pricing Issues	93
6.3	Analysis Under Existing Regime	93
6.3.1	FS' Sales of Tangible Property to USP	93
6.3.2	USP's Sales of Tangible Property to FS	95
6.4	Analysis Under Alternative Regime	98
6.5	Comparison	99
7	Performance of Intercompany Services	101
7.1	Summary of Key Facts	102
7.2	Transfer Pricing Issues	104
7.3	Value of Customer Relationships	104
7.3.1	Declining Average Prices	106
7.3.2	Rapid Rates of Technological Change	108
7.3.3	Established Customer Relationships	109
7.4	Analysis Under Existing Regime	110
7.4.1	Application of Best Method Rule	110
7.4.2	Application of Selected Method: CRM Services	111
7.4.3	Application of Selected Method: R&D Services	112
7.5	Analysis Under Alternative Regime	113
7.6	Comparison	114
8	Replication of Internet-Based Business Model	115
8.1	Summary of Key Facts	115
8.1.1	USP: Business Development Group	116
8.1.2	USP: Account Management Group	116
8.1.3	USP: Marketing Group	117
8.1.4	USP: Information Technology Group	117
8.1.5	USP: Customer Service	117
8.1.6	USP: Legal	118
8.1.7	USP: Finance, Tax, Internal Audit and Back-Office	118
8.1.8	FS	118
8.2	Transfer Pricing Issues	118

8.3	Analysis Under Existing Regime	119
8.4	Analysis Under Alternative Regime.....	120
8.5	Conclusions	123
9	Sale of Assets with Embedded Intellectual Property	125
9.1	Summary of Key Facts	125
9.2	Transfer Pricing Issues	129
9.3	Analysis Under Existing Regime	129
9.4	Analysis Under Alternative Regime.....	132
9.4.1	USS' Estimated Cost of Equity Capital	133
9.4.2	Estimated Value of USS' Equity Capital	133
9.4.3	Cost of Debt	134
9.4.4	Required Return on Capital Assuming Statutory Tax Rate Applies	134
9.4.5	Adjustments to Reflect Loss Carryforwards, Other Firm-Specific Factors	135
9.5	Comparison	135
10	Provision of CDN Services to Third Parties	137
10.1	Summary of Key Facts	137
10.2	Transfer Pricing Issues	140
10.3	Analysis Under Existing Regime	140
10.4	Analysis Under Alternative Regime.....	141
10.5	Additional Analysis Under Alternative Regime	143
10.6	Comparison	144
11	Global Trading of Commodities	145
11.1	Summary of Key Facts	145
11.1.1	Description of Natural Gas Markets	145
11.1.2	Description of Alumina and Aluminum Markets	147
11.1.3	Core Assets and Skills	148
11.1.4	Recent Developments and Their Effect on the Relative Importance of Core Assets and Skills	151
11.1.5	Effects of Developments on Trading Activities.....	153
11.1.6	Division of Labor and Risks Among Group Members	154
11.2	Transfer Pricing Issues	155
11.3	Analysis Under Existing Regime	155
11.4	Analysis Under Alternative Regime.....	156
11.5	Comparison	160
12	Decentralized Ownership of Intellectual Property	161
12.1	Summary of Key Facts	162
12.2	Transfer Pricing Issues	164
12.3	Analysis Under Existing Regime	165

12.3.1	Assuming USP and FS Act to Maximize Their Individual Profits	165
12.3.2	Assuming FS and USP Act as Joint Venture Partners	166
12.4	Analysis Under Alternative Regime	171
12.4.1	Key Terms of JV Agreements	172
12.4.2	Summary of Qualitative Observations	173
12.4.3	Quantitative Analysis	174
12.5	Analysis Under 2005 Proposed Cost-Sharing Regulations	175
12.5.1	Income Method	176
12.5.2	Market Capitalization Method	179
12.6	Comparison	179

Part IV Conclusions

13	Concluding Observations	183
Index	187