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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATED: August 6, 1999

MEMORANDUM FOR:

FROM: Steven A. Musher
Chief
CC:INTL:6

SUBJECT:

This Field Service Advice responds to your memorandum dated April 1, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

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Date H	=	
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Merchandise	=	
Parent	=	
Period 0	=	
Period 1	=	
Period 2	=	
Period 3	=	
Period 4	=	
Petitioner	=	
Product A	=	
Product B	=	
Rate A	=	
Rate B	=	
Rate C	=	
Rate D	=	
USSub.	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Year 5	=	

ISSUES:

1. Whether application of the comparable profits method (CPM) under section 482 requires adjustments, based on the potential for imposition of antidumping duties on U.S. imports of tangible merchandise, and the obligation to post cash deposits for the estimated amount of such duties.

2. Whether the taxpayer must ignore antidumping duty deposits as "extraordinary," or consistently treat them both for purposes of determining taxable income and evaluating arm's length results for purposes of section 482.

3. Assuming that the taxpayer's basic position with respect to antidumping duties and deposits were correct, whether it correctly calculated the adjustment to income pursuant to Treas. Reg. §§ 1.482-1(a)(3) and 1.482-1(f)(2)(iii).

CONCLUSIONS:

1. Yes. To the extent exposure to the risk of antidumping duties, the requirement to post cash deposits, and other associated economic conditions and circumstances constitute 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. Treas. Reg. §§ 1.482-5(c)(2)(iv), 1.482-1(d)(2).

2. No. The potential for antidumping duties cannot simply be ignored, since it represents a material difference in risks, economic conditions, or other circumstances between the taxpayer and the comparables. Eventual refunds, or imposition of duties in excess of deposits, may, however, constitute "extraordinary" items for purposes of the analysis. Provided appropriate adjustments are made to ensure that comparisons are valid in the transfer pricing analysis, the starting points for the determination of taxable income and the evaluation of arm's length results need not be identical.

3. No. Assuming the taxpayer's position were correct, it should have adjusted its operating profit for the year in question to the median of the comparables for that year, rather than make a single-year adjustment that brought taxpayer's three-year average operating profit within the range of the three-year averages for the comparables. Treas. Reg. §§ 1.482-1(f)(iii)(D), 1.482-5(e), Examples 2 and 3.

FACTS:

USSub. is a domestic corporation and a wholly-owned subsidiary of Parent. USSub. distributes and manufactures Merchandise in the United States.

Introduction: Statutory Scheme for Imposition of Antidumping Duties

Because this case involves antidumping duties, we briefly review the statutory and regulatory framework for imposition of such duties, before turning to the specific facts of this case.

The Antidumping Duty Law in General

The antidumping law seeks to reduce harm to a domestic industry caused by U.S. sales of imported merchandise at less than fair value. City Lumber Co. v. United States, 311 F. Supp. 340 (Cust. Ct. 1970), aff'd, 457 F.2d 991 (C.C.P.A. 1972). Merchandise is said to be dumped if its U.S. price is less than its foreign market value. Generally, foreign market value consists of the F.O.B. factory price at which "such or similar merchandise" is sold in the home market. In cases involving related parties, U.S. price consists of the arm's length resale price in the United States, adjusted to approximate the hypothetical amount received by the foreign manufacturer, i.e., the "net amount returned to the foreign exporter."[1] See Brother Industries, Ltd. v. United States, 540 F. Supp. 1341, 1357 (Ct. Int'l Trade 1982), aff'd sub nom. Smith-Corona Group v. United States, 713 F.2d 1568 (Fed. Cir. 1983). If U.S. price is determined to be lower than foreign market value, the U.S. Department of Commerce (Commerce) orders the U.S. Customs Service (Customs) to collect, on all imports of subject merchandise, an antidumping duty equal to the differential (or dumping margin).

Initial Investigation and Suspension of Liquidation

In general, an antidumping investigation is begun in response to a petition filed on behalf of a domestic industry. An antidumping duty petition alleges imports of merchandise at less than fair value and that the imports have caused (or threaten to cause) material injury to the domestic industry producing a "like product." See 19 U.S.C. § 1673 and following. If the petition meets the requirements, Commerce and the U.S. International Trade Commission (ITC) initiate investigations regarding, respectively, sales at less than fair value and material injury to the domestic industry.

If Commerce and the ITC issue affirmative final determinations, Commerce publishes an antidumping duty order. Upon publication of the order, Commerce instructs Customs to suspend liquidation (assessment of customs duties and charges) with respect to the subject imports. Commerce also requires identified importers to post, at the time of entry of merchandise for consumption (or withdrawal from warehouse), cash deposits of estimated antidumping duties. These deposits, calculated based on the customs value of the merchandise, approximate the margin below fair value at which the merchandise was sold in the United States during the initial Commerce investigation.

Administrative Review and Imposition of Antidumping Duties

During the anniversary month of publication of the antidumping duty order, an importer of subject merchandise or a domestic interested party may request Commerce to conduct an administrative review, which will determine the final dumping margin for entries in the preceding annual period. Deposits of estimated antidumping duties on entries during that period are taken into account in one of two ways:

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[1] If the first sale of dumped merchandise is to a unrelated entity in the United States, the U.S. price of the merchandise for antidumping purposes is generally determined by reference to the price to the unrelated entity, rather than the price to the resale customer. See PQ Corp. v. United States, 652 F. Supp. 724, 731-33 (Ct. Int'l Trade 1987); 19 U.S.C. § 1677a(b) (1994). In such cases, U.S. price is also subject to different (and fewer) adjustments than if a related entity resold the merchandise in the United States.

1. No administrative review requested. Commerce instructs Customs to liquidate entries with antidumping duties equivalent to the deposit amount (no refund or additional duty).

2. Administrative review conducted. Commerce determines dumping margins for all transactions in the review period and issues instructions to Customs for collection of the appropriate duty:

   a. If the dumping margin is more than the deposit amount, Customs collects the additional duty.

   b. If the dumping margin is less than the deposit amount, Customs refunds the difference to the importer, together with interest calculated from the date of entry to the date of liquidation.

See 19 U.S.C. § 1675.

Modification of Cash-Deposit and Duty Rates

The importer-specific dumping margin contained in the "final results" of an administrative review provides the basis for liquidation instructions to Customs for individual importers' entries in the annual period, as well as the estimated duty-deposit rate for entries after the date of the determination (i.e., until the deposit rate is superseded by a subsequent administrative review).

Significant time may elapse between Commerce's administrative-review determination and actual collection of antidumping duties. Commerce is authorized to issue liquidation instructions to Customs when the administrative review is completed. Yet, importers and domestic interested parties may seek judicial review of the administrative review results. Because liquidation of the underlying entries could moot judicial review, the U.S. Court of International Trade (CIT) customarily enters a preliminarily injunction restraining liquidation. Given that such injunctions generally remain in effect for the duration of the CIT action (and during remands or appeals therefrom), several years may elapse between the date of an entry subject to antidumping scrutiny and Customs' final liquidation of that entry.

Antidumping Proceedings Involving Taxpayer

In Date A, Petitioner, a U.S. producer of Product A, filed an antidumping petition alleging that USSub. and Parent (among others) engaged in sales of Product B at less than fair value (LTFV), and that those sales caused, or threatened to cause, material injury to the domestic industry producing a "like product."

In Date B, after affirmative determinations by both agencies, Commerce issued an antidumping duty order with respect to Product B. For entries on or after Date C, USSub. was required to post cash deposits with Customs, equal to Rate A of the entered customs value of the merchandise. USSub.'s cash-deposit rate, stated as a percentage of entered customs value, approximated the LTFV margin determined for USSub. sales during the period of investigation.

Commerce issued the following final determinations with respect to Product B imported by USSub.

Proceeding	Entry Dates	Margin	Commerce Determination (Date)
Fair Value Invest.	Period 0	Rate A	Citation A
First Review	Period 1	Rate B	Citation B
Second Review	Period 2	Rate C	Citation C
Third Review	Period 3	Rate C	Citation D
Fourth Review	Period 4	Rate D	Citation E

USSub. entries of Product B from Date C to Date D were subject to a cash-deposit requirement equal to Rate A.[2] Commerce's determination on Date D that USSub. imports in the first review period were not dumped entitled USSub. to refunds of cash deposits for that period, with interest (although refunds might be delayed pending the outcome of judicial review). Moreover, for entries after that date, USSub. was not required to post cash deposits, unless and until Commerce determined dumping margins that were more than de minimis (i.e., more than 0.5%) in a subsequent administrative review.

As of the date of this memorandum, it appears that only USSub. entries in the third administrative review (Period 3) have been subject to liquidation. For the first and second administrative reviews, the domestic interested party initiated judicial review, and likely obtained preliminary injunctions restraining liquidation of the underlying entries. However, for the third administrative review, it does not appear that an injunction was obtained with respect to USSub.'s entries (although this point should be verified by the Field).[3] Therefore, as of Date E,

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[2] Entries between the date of Commerce's preliminary determination and the publication of the order were subject to bonding requirements, and might ultimately be subject to antidumping duties. However, the cash-deposit requirement per se generally does not apply to entries made prior to the effective date of the antidumping duty order. See 19 U.S.C. § 1673b(d)(2) (1994).

[3] See Action 1. In Date F,

Commerce was authorized to issue, and likely did issue, liquidation instructions with respect to USSub. entries in the third review period. Because Commerce found de minimis dumping margins for USSub. in that period, Commerce would have ordered refunds to USSub. of all antidumping duty deposits for entries in Period 3.

Taxpayer's Tax Treatment of Antidumping Duty Deposits

In computing taxable income, USSub. included cash deposits of antidumping duties in cost of goods sold, and deducted such deposits as it consumed inventory. Thus, although liability for antidumping duties was contingent, and although cash deposits might be refunded with interest, USSub. deducted the deposits from income in Years 1 and 2. Total deposits were approximately $a in Year 1, $b in Year 2, and $c Year 3. Cumulative deposits as of the end of Year 3 were approximately $e.

On Date G, USSub. filed Form 3115, Application for Change in Accounting Method, for Year 5. USSub. requested permission to change from deducting antidumping duty cash deposits as a component of cost of goods sold (as it had done since cash deposits were first required in Year 1) to deducting them only when (and if) antidumping duty liability was finally imposed, upon liquidation. On Date H, the National Office granted USSub.'s request, and required that it recognize income of $e in each of five consecutive years, beginning in Year 5, pursuant to section 481(a). The cumulative adjustment of $f is the difference between costs under the taxpayer's old and new methods of accounting. The adjustment prevents double-deduction of deposits, i.e., initially when inventory was consumed, and again when duties were assessed in a subsequent tax year. Under USSub.'s new method of accounting, which became effective in Year 5, cash deposits and refunds of such deposits have no effect on taxable income.

Taxpayer-Initiated Adjustment Pursuant to Section 482

On a timely-filed tax return for Year 3, USSub. made an adjustment pursuant to Treas. Reg. § 1.482-1(a)(3) and the comparable profits method (CPM) of Treas. Reg. § 1.482-5, which reduced its income, as the tested party, by $g. A large portion of this adjustment was attributed to cumulative antidumping duty deposits of $d made in Years 1-3. USSub. argued that these deposits were properly eliminated from operating profit as "extraordinary items," pursuant to Treas. Reg. § 1.482-5(d)(3) and (4). USSub. reduced its income for Year 3 by an additional $h, in order to place USSub.'s three-year average operating profit -- stated on a basis that excluded the effect of antidumping duty deposits -- within the interquartile range of operating profits of the comparables.

In calculating the self-adjustment to Year 3 pursuant to Treas. Reg. § 1.482-1(a)(3), USSub. did not deduct antidumping duty deposits for purposes of calculating operating profit.[4] USSub.'s Year 1-3 operating profit data, with antidumping duties excluded from cost of goods sold, yields the following ratios of operating profit to sales (OP/S):

Year 1	Year 2	Year 3	Wt. Avg.
i%	j%	k%	l%

In contrast, USSub.'s 1993-95 operating profit data, calculated with antidumping duties included as components of cost of goods sold, yield the following OP/S ratios:

Year 1	Year 2	Year 3	Wt. Avg.
m%	n%	o%	p%

The corresponding OP/S ratios for the non-controlled comparables were as follows:

	Year 3	Avg., Yrs. 1-3
Third interquartile	q%	r%
Median	s%	t%
First interquartile	u%	v%

It is assumed solely for purposes of this advice that the CPM constitutes the "best method" in this case, and that OP/S constitutes the appropriate profit level indicator (PLI).

LAW AND ANALYSIS:

Issue 1: Adjustment under CPM to Reflect Potential Imposition of Antidumping Duties

The CPM compares the profitability of the tested party's relevant business activity that incorporates the controlled transactions, measured by a PLI (often based on operating profit), to the profitability of the similar business activities including the corresponding uncontrolled transactions of uncontrolled taxpayers, the comparables, in similar circumstances. Treas. Reg. § 1.482-5(c)(2)((i). The PLI should be derived from a sufficient number of years of data to reasonably measure returns that accrue to the comparables. Treas. Reg. § 1.482-5(b)(4). Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years, i.e., Years 1-3 in this case. Id. As with all methods that rely on external market benchmarks, the greater the degree of comparability between the test party's and

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[4] In this context, the exclusion of antidumping duty deposits (an expense item) from cost of goods increases apparent gross operating profit.

the comparables' transactions, the more reliable will be the results derived from the application of the method, and the degree of comparability depends upon all the relevant facts and circumstances. Id. The degree of comparability is determined by applying the provisions of Treas. Reg. § 1.482-1(d)(2). Id.

Comparability does not require identity between the controlled and uncontrolled transactions, but those transactions must be sufficiently similar so that the uncontrolled transaction provides a reliable measure of an arm's length result. Treas. Reg. § 1.482-1(d)(2). If there are differences between the tested party's relevant business activity including the controlled transactions and the comparables' business activities including the uncontrolled transactions that would materially affect the profits determined under the relevant PLI, 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. Treas. Reg. §§ 1.482-5(c)(2)(iv), 1.482-1(d)(2). Generally, such adjustments must be made to the results of the uncontrolled comparables and must be based on commercial practices, economic principles, or statistical analyses. Treas. Reg. § 1.482-1(d)(2). If adjustments for material differences cannot be made, the uncontrolled transactions may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced. Id.

Although all of the factors described in Treas. Reg. § 1.482-1(d)(3) must be considered, comparability under the CPM is particularly dependent on resources employed and risks assumed. Treas. Reg. § 1.482-5(c)(2)(ii). Other factors listed in Treas. Reg. § 1.482-1(d)(3) also may be particularly relevant under the CPM. One such factor is a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in the controlled and uncontrolled transactions. Treas. Reg. § 1.482-1(d)(3)(iv).

The degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Treas. Reg. § 1.482-1(d)(3)(iii)(A). Such a comparison necessitates an analysis of the circumstances of the controlled and uncontrolled transactions. Regarding a controlled transaction, if the contractual arrangement specifically provides for an allocation of a particular risk, the allocation of risks so specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. Treas. Reg. §§ 1.482-1(d)(3)(iii)(B), 1.482-1(d)(3)(ii)(B). In the absence of a written agreement, the contractual arrangement regarding the controlled transaction may be imputed consistent with the substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2). In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights. Id. An allocation of risk after the outcome of such risk is known or reasonably knowable lacks economic substance. Treas. Reg. § 1.482-1(d)(3)(iii)(B).

In our view, the potential for antidumping duties and the associated obligation to post deposits likely constitute significant risks, economic conditions, or other circumstances that would materially affect the prices that would be charged or paid, or the profit that would be earned in connection with the importation of the affected merchandise, and would likely have been taken into account by parties at arm's length. This risk, condition, or circumstance existed with respect to the taxpayer's relevant business activity including the controlled transactions, but not with respect to the comparables' business activities including the uncontrolled transactions. Accordingly, 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.

In accordance with the above-cited regulatory provisions, the incidence of the antidumping associated risks must be determined as of the time the controlled transactions were entered into, not after-the-fact, once the outcome of such risk is known or reasonably knowable. Thus, taxpayer cannot argue that USSub. did not bear any risk different than the comparables, just because taxpayer already knew, or could reasonably know, at the time it filed its return for Year 3 that, in fact, no duties could be imposed on the Year 3 entries and that the corresponding deposits would be refunded.[5] Rather, it was incumbent upon the taxpayer at the time it filed its Year 3 return to report its operating income in light of the risks, economic conditions, and other circumstances existing at the time of the transactions.

Examination needs to develop the facts surrounding the controlled transactions to ascertain the relevant allocation of risks, the economic conditions, and the other circumstances attendant to the potential for antidumping duties and the requirement to make deposits. Any contractual agreements expressly or impliedly addressing the risk allocation should be examined. In the absence of such expressly applicable agreements, Examination may impute an arrangement allocating the risk consistent with the economic substance of the controlled transactions, giving greatest weight to the actual conduct of the parties and their legal rights.

In this case, important legal rights of the parties are defined under the antidumping laws, including implementing regulations. Prior to 1980, importers subject to antidumping duty orders were generally permitted to post bonds as security for antidumping duties that were ultimately determined to be due. A new cash-deposit requirement was implemented by Title I of the Trade Agreements Act of 1979, which repealed the Antidumping Act of 1921 and enacted in its place Title VII of the Tariff Act of 1930, as amended. The legislative history of the Trade Agreements Act of 1979 indicates that Congress intended the cash-deposit requirement to provide the domestic industry prompt relief from dumping and to act as a strong incentive for affected importers to submit the information necessary for determination of final antidumping duties. See

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[5] As of Date G, Commerce had issued a final determination of no dumping by USSub. for the first administrative review, and a similar preliminary determination for the second review. The last USSub. entries in the third administrative review entered U.S. commerce on Date I. Thus, before it filed its return for Year 3, USSub. could analyze all of its entries in Year 3, and could evaluate the likelihood that Commerce would impose antidumping duties.

Sen. Rep. No. 249, 96th Cong. 1st Sess. 76-77 (1979), reprinted in 1979 U.S.C.C.A.N. 381, 462-63; see also H.R. Rep. No. 317, 96th Cong. 1st Sess. 69 (1979).

Congress recently indicated that the incidence of antidumping duties should be on U.S. importers. In the Uruguay Round Agreements Act of 1994, Congress specified that duty-reimbursement should be considered as a (negative) factor in proceedings involving revocation of existing antidumping duty orders. See 19 U.S.C. § 1675(a)(4) (1995); see also Sen. Rep. No. 412, 103d Cong., 2d Sess. 44 (1994).

Commerce regulations specifically prohibit reimbursement of antidumping duties to the importer (USSub. in this case). 19 C.F.R. § 353.26(b). See also 19 C.F.R. § 351.402(f) (1998).[6] An importer subject to an antidumping duty order must certify, prior to importation, that it has no "agreement or understanding for the payment or for the refunding to [it] by the manufacturer, producer, seller, or exporter of all or any part of the antidumping duties assessed upon [imports of the merchandise]." 19 C.F.R. § 353.26(b). If the importer fails to provide the necessary certification, Commerce may deduct from U.S. price any amounts deemed to be reimbursed, potentially doubling the amount of antidumping duty payable. Because cash deposits are credited against the amount of final duties assessed, the underlying obligations for deposits and duties are closely linked. The party who posts the cash deposit in any given case is in effect the same party who assumes liability for final antidumping duties, as assessed.

Commerce has stated that "the remedial effect of the [antidumping] law is defeated . . . where exporters themselves pay antidumping duties, or reimburse importers for such duties." Color Television Receivers from the Republic of Korea, 61 Fed. Reg. 4408, 4410 (Dept. Comm. 1996). Moreover, Commerce may determine that reimbursement has occurred if "evidence demonstrates that the exporter directly pays antidumping duties for the related importer or reimburses the importer for such duties." Color Television Receivers from the Republic of Korea, 61 Fed. Reg. at 4411.

Applying this standard, Commerce has on several occasions found prohibited reimbursement. See Hoogovens Staal BV, et al. v. United States, 4 F. Supp. 2d 1213, 1217 (Ct. Int'l Trade 1998) (listing determinations finding reimbursement). However, interpretation of the regulation in this manner is relatively recent. See Hoogovens, 4 F. Supp. 2d at 1217 (noting change in practice). In several earlier cases, Commerce refused to investigate reimbursement, absent written evidence in the administrative record that the practice occurred. See The Torrington Co. v. United States, 127 F.3d 1077 (Fed. Cir. 1997).

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[6] The antecedent of the current reimbursement regulation was issued by what was then the Bureau of Customs, pursuant to the Antidumping Act of 1921. See T.D. 55286, 96 Treas. Dec. 7 (1961). See also 19 C.F.R. § 14.9(f) (1961). The reimbursement regulation, with changes in wording and numbering, has been in force from 1961 to the present.

The legal rights of the controlled parties thus support the view that, at the time of importation, USSub. bore the risk that antidumping duties would ultimately be assessed on the imported merchandise. That is, the antidumping statute and regulations apparently place the burden of antidumping duties on the U.S. importer, and may impose negative consequences if duties are reimbursed by another party.

As noted, adjustments must be made to account for the potential imposition of antidumping duties to the extent this represents a significant risk, economic condition, or other circumstance that would materially affect the prices that would be charged or paid, or the profit that would be earned in connection with the importation of the affected merchandise, provided the effect of such risk, economic condition, or circumstance on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. Such adjustments must generally be made to the results of the uncontrolled comparables and must be based on commercial practices, economic principles, or statistical analyses. Treas. Reg. § 1.482-1(d)(2).

In this case, the adjustment may be thought of as corresponding to the premium an uncontrolled taxpayer would have demanded under circumstances comparable to those faced by USSub. In our view, the Service may consider the cash deposit rate as in effect from time to time as evidence relevant to what that premium might be. The CPM analysis for Year 3 spans the three-year period Years 1-3. Again, in accordance with the above-cited regulatory provisions, the incidence of the antidumping associated risks must be determined as of the time the controlled transactions were entered into, not after-the-fact, once the outcome of such risk is known or reasonably knowable. Thus, in our view, the Service may consider Rate A in determining the premium an uncontrolled taxpayer might demand with regard to imports of affected merchandise during Years 1-3.[7] Of course, this evidence must be evaluated in light of the transfer pricing regulations and any other relevant evidence. Further adjustments may be warranted in light of that evaluation. Consequently, additional factual and economic analysis may be necessary to determine the appropriate adjustment in this case.

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[7] Within Year 1 in Date B, Commerce ordered cash deposits on entries of Product B, beginning with Date C in Year 1, at Rate A. Rate A remained in effect until Date D in Year 4 when Commerce issued its determination that USSub.'s imports in the first review period were not dumped and so entitled USSub. to refund of cash deposits for Period 1, including Year 1 and part of Year 2. As of Date G in Year 4, Commerce had issued a final determination of no dumping by USSub. for the first administrative review, and a similar preliminary determination for the second review period, i.e., Period 2, including the balance of Year 2 and part of Year 3. The last USSub. entries in the third administrative review period, i.e., Period 3 including the balance of Year 3 and part of Year 4, entered U.S. commerce on Date I in Year 4. Commerce's actions in Year 4 and other Year 4 data, however, are not relevant, assuming they could not reasonably be anticipated in Years 1-3.

Issue 2: "Extraordinary" or Consistent Treatment of Antidumping Duty Deposits

Taxpayer's argument that the cash deposits were properly eliminated from operating profit as "extraordinary items," pursuant to Treas. Reg. § 1.482-5(d)(3) and (4), as well as the argument that deduction of such deposits similarly were eliminated under the change of method of accounting granted by the Service, must be considered in the context of the above discussion.

As discussed, in our view the potential imposition of antidumping duties is likely a material difference in risks, economic conditions, or other circumstances between the taxpayer and the comparables that requires adjustment under the regulations. From this perspective this potential is not "extraordinary" and requires some consideration in the analysis.

On the other hand, that consideration does not necessarily involve deducting the amounts of the cash deposits in determining USSub.'s operating profit for purposes of the CPM. In line with the foregoing discussion, the adjustment for the antidumping duty potential may be to reflect a premium over and above the normal returns of the comparables. The cash deposit rate as in effect from time to time is evidence relevant to what that premium might be, although it may not be identical with the premium that the Service ultimately determines to be appropriate. Thus, one possible approach would be to back out the cash deposit amounts from USSub.'s cost of goods sold, but then add in the appropriate premiums into the returns of the comparables for purposes of the comparison under the CPM.

Alternatively, premium amounts might indeed be deducted in computing USSub.'s operating profits. No adjustment would then be made to the returns of the comparables for purposes of the comparison under the CPM. Under either the approach taken in this or the preceding paragraph, the eventual refund of cash deposits, or the imposition of duties in excess of prior deposits, would represent extraordinary gains, or losses, that should be excluded from the computation of the operating profit of USSub. or the comparables. Treas. Reg. § 1.482-5(d)(3) and (4).

Provided appropriate adjustments are made to ensure that comparisons are valid in the transfer pricing analysis, the starting points for the determination of taxable income and the evaluation of arm's length results need not be identical. See Treas. Reg. § 1.482-5(d)(5)("If the comparable operating profit of the tested party is determined from profit level indicators derived from financial statements or other accounting records and reports of comparable parties, adjustments may be made to the reported operating profit of the tested party in order to account for material differences between the tested party's operating profit reported for U.S. income tax purposes and the tested party's operating profit for financial statement purposes.").

In any event, the approach adopted by the taxpayer is inappropriate, i.e., both to back out the cash deposit amounts from USSub.'s cost of goods sold and then to leave the returns of the comparables unadjusted. The problem with that approach is its failure to make any adjustment regarding USSub.'s antidumping duty exposure.

We note that, under the position herein, arm's length pricing and antidumping policies are mutually reinforcing. By adjusting the application of the CPM to reflect the differences between USSub. and the comparables with reference to the potential for antidumping duties, USSub. is, in effect, required to report the same operating profit whether or not dumping occurs. In other words, this position avoids creating a tax advantage to dumping. Conversely, to assume that USSub.'s results, as measured with reference to the comparables, should be unaffected by potential dumping, would imply an arrangement in which the financing of deposits, the benefit of any refunds, and the burden of any final duties in excess of deposits, are at the risk of Parent. Such an arrangement would contravene the Commerce regulations, which dictate that such risk rests with USSub.

Issue 3: Evaluation of Taxpayer-Initiated Adjustment Performed by USSub.

The foregoing sections set forth substantive shortcomings in the taxpayer's CPM analysis. Even assuming that the taxpayer's basic position with respect to antidumping duties and deposits were correct, however, it incorrectly calculated the adjustment to Year 3 income pursuant to Treas. Reg. §§ 1.482-1(a)(3) and 1.482-1(f)(2)(iii).

The taxpayer made its Year 3 adjustment pursuant to Treas. Reg. § 1.482-1(a)(3), which permits a controlled taxpayer, if necessary to reflect an arm's length result, to report a decrease in taxable income from its controlled transactions based on prices different than those actually charged, but only on a timely filed U.S. income tax return (including extensions). In our view, a taxpayer-initiated adjustment must comply with the same rules as apply for Service-initiated adjustments.

In making its Year 3 adjustment under the CPM, the taxpayer compared USSub.'s average operating profit to the interquartile range of the comparables for the three-year period Year 1-3. Treas. Reg. § 1.482-5(b)(4) provides in pertinent part:

> The profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years. This analysis must be applied in accordance with § 1.482-1(f)(2)(iii)(D).

Accord, Treas. Reg. § 1.482-1(e)(3)(regarding adjustment if taxpayer's results are outside arm's length range, "See § 1.482-1(f)(2)(iii)(D) for determination of an adjustment when a controlled taxpayer's result for a multiple year period falls outside an arm's length range consisting of the average results of uncontrolled comparables over the same period.").

Treas. Reg. § 1.482-1(f)(2)(iii)(D) provides:

> *Applications of methods using multiple year averages.* If a comparison of a controlled taxpayer's average result over a multiple year period with the average results of uncontrolled comparables over the same period would reduce the effect of short-term variations that may be unrelated to transfer pricing, it may be appropriate to establish a range derived from the average results of uncontrolled comparables over a multiple year period to determine if an adjustment should be made. In such a case the district director may make an adjustment if the controlled taxpayer's average result for the multiple year period is not within such range. Such a range must be determined in accordance with § 1.482-1(e)(Arm's length range). An adjustment in such a case ordinarily will be equal to the difference, if any, between the controlled taxpayer's result for the taxable year and the midpoint of the uncontrolled comparables' result for that year. <u>If the interquartile range is used to determine the range of average results for the multiple year period, such adjustment will ordinarily be made to the median of all the results of the uncontrolled comparables for the taxable year. See *Example 2* of § 1.482-5(e).</u> In other cases, the adjustment normally will be made to the arithmetic mean of all the results of the uncontrolled comparables for the taxable year. <u>However, an adjustment will be made only to the extent that it would move the controlled taxpayer's multiple year average closer to the arm's length range for the multiple year period or to any point with in such range.</u> In determining a controlled taxpayer's average result for a multiple year period, adjustments made under this section for prior years will be taken into account only if such adjustments have been finally determined as described in § 1.482-1(g)(2)(iii). See *Example 3* of § 1.482-5(e). (Emphasis added.)

<u>See also</u> Treas. Reg. § 1.482-5(e), *Example 2(iii)* ("To determine the amount, if any, of the allocation, the district director compares USSub's reported operating profit for 1996 to comparable operating profits derived from the uncontrolled distributors' results for 1996."); Treas. Reg. § 1.482-5(e), *Example 3(iii)*.

In this case, the foregoing rules require that if USSub.'s Year 1-3 average operating profit is outside the interquartile range of the comparables' Year 1-3 average operating profits, then the adjustment will ordinarily be made to the median of all the results of the uncontrolled comparables <u>for the taxable year</u>, i.e., Year 3. Note, the stated condition would be met, since a downward adjustment of USSub.'s operating profit for Year 3 from k% to s%, the median of the comparables' Year 1-3 results, would move USSub.'s Year 1-3 average (l% before adjustment, w% after adjustment) <u>closer to</u> the limit of the interquartile range of the comparables for the three-year period (r%). The taxpayer, however, performed a far larger one-year adjustment, sufficient in itself to move USSub.'s Year 1-3 average <u>within</u> the Year 1-3 comparable range.

Reducing USSub.'s operating profit from $x to $y would result in an OP/S ratio of s% for Year 3, i.e., the median of the results of the comparables for that year. Thus, even assuming that USSub.'s legal analysis is valid, the maximum permissible adjustment under Treas. Reg. § 1.482-1(f)(2)(iii)(D) for Year 3 is only $z, rather than the $g calculated by USSub.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

If you have any questions regarding this matter, please call Branch 6 at (202) 874-1490.

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