Tax Insights

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IRS Memorandum Sets Forth New Vision for Periodic Transfer Pricing Adjustments Departing from the Arm's Length Standard

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Client Impact

The section 482 regulations authorize the Internal Revenue Service ("IRS") to use *ex post* profitability data to make so-called "periodic adjustments" to the consideration paid for intercompany transfers and licenses of intangibles. To date, it appears the IRS has seldom, if ever, used this authority in practice, and prior IRS guidance endorsed a limited role for periodic adjustments.

A Chief Counsel memorandum released on January 17, 2025, AM 2025-001, articulates a more robust interpretation of periodic adjustments and suggests that they may be becoming an IRS enforcement focus. Given this renewed focus, taxpayers should consider their potential exposure to periodic adjustments and how it could be reduced.

This article discusses the IRS's embrace of ex post profitability data as a basis for periodic adjustments, emphasizing the need for taxpayers to carefully consider strategies like advance pricing agreements and true-up mechanisms to mitigate potential risks.

Background and Analysis

In 1986, Congress amended section 482 to provide that the income with respect to any transfer or license of intangible property "shall be commensurate with the income attributable to the intangible." [1] Legislators were concerned that inappropriate comparables were being used to undervalue outbound transfer of intangibles. The legislative history behind the 1986 amendment indicates an intent that *ex post* data be used to evaluate whether transactional

pricing satisfies the commensurate with income ("CWI") standard. Treasury has promulgated regulations implementing the CWI standard via periodic adjustments for IP licenses and transfers, [2] as well as in the cost sharing arrangement ("CSA") context. [3]

In 2007, IRS Chief Counsel interpreted the CWI standard as allowing the IRS to "provisionally . . . treat actual profits as evidence of projected profits and make periodic adjustments as if such results were projected at the time of the controlled intangible transfer," while noting that "[t]axpayers may rebut such presumption, e.g., by showing that such results were beyond the control of the taxpayer and could not reasonably have been anticipated at the time of the transaction." [4]

In AM 2025-001, Chief Counsel in effect abandons the conclusion it reached in 2007 that adjustments to income should generally be based on projected profits at the time of the transfer of the intangible. The new memorandum endorses the use of *ex post* data as definitive rather than provisional evidence of arm's length outcomes, absent the application of one of the (narrowly drawn) exceptions provided in the regulations. **The memorandum concludes that even in cases where the taxpayer selected the best method, unless an exception applies, the IRS may still make periodic adjustments and such adjustments are deemed to be arm's length.**

The memorandum, which only announces the IRS position and does not alter the underlying authorities, may signal an intent to include periodic adjustments among the IRS' transfer pricing enforcement priorities. Doing so could effect a sea-change for transfer pricing: although we have experience with the IRS raising CWI issues on exam, we are not aware of any cases in which it has proposed a periodic adjustment as such. [5] What is more, **periodic adjustments as envisioned by AM 2025-001 sit entirely outside the normal transfer pricing framework, essentially giving the IRS a trump card for IP cases, except where the taxpayer can prove it qualifies for an exception**.

AM 2025-001: Analysis

AM 2025-001 posits two situations. In the first, the taxpayer licenses intangible property ("IP") and applies the comparable uncontrolled transaction ("CUT") method using an uncontrolled license of IP that the taxpayer determines to be comparable, but that is subject to different limitations on use than the controlled IP. The memorandum assumes that this application of the CUT method was the best method "[o]f the methods available to the Taxpayer," but the difference in limitations on use causes it not to qualify for the CUT exception to periodic adjustments under Treas. Reg. section 1.482-4(f)(2)(ii). [6] In subsequent years, the market share for the product using the IP grows and the IRS makes periodic adjustments. In the second situation, the taxpayer makes a platform contribution transaction ("PCT"), which it values using the income method based on the projected profits from the intangibles reasonably anticipated to be developed; actual profits turn out to be higher, and the IRS makes periodic adjustments. Here too, the taxpayer does not qualify for any of the exceptions provided for in the regulation.

In both situations, the IRS concludes that periodic adjustments are *per se* appropriate and cannot be overturned by the taxpayer invoking "the general ALS under Treas. Reg. section 1.482-1(b)(1) or the best method rule of Treas. Reg. section 1.482-1(c)." [7]

Even when a taxpayer can show that it used the best method in light of the information available at the time of a transaction, the IRS can still make periodic adjustments, and such periodic adjustments are—according to Chief Counsel's position—the end of the matter unless one of the regulatory exceptions applies. Both Treas. Reg. sections 1.482-4(f)(2)(ii)(D) and 1.482-7(i)(6)(vi)(A)(2) provide exceptions to periodic adjustments, including

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exceptions where the divergence is due to extraordinary events that were beyond the parties' control and could not have been reasonably anticipated at the time of the transaction. [8] The memorandum takes a broad view of foreseeability, and consequently a narrow view of the "extraordinary events" exceptions' potential application: "This exception would not be satisfied if the higher actual profits resulted from, for example . . . revenues considered possible (or indicated to potential investors to be possible) by the taxpayer group but not considered sufficiently likely to be reflected in financial projections." [9]

Treasury and the IRS have historically taken a strong view on the consistency of the arm's length standard and the CWI standard, as laid out in Treasury's 1988 White Paper [10] and in AM 2007-007. The new memorandum purports to continue in that tradition, but in effect turns it on its head by concluding that periodic adjustments are *per se* arm's length: "The constraints imposed on periodic adjustments, by limiting their use to high-profit-potential intangibles, ensure that periodic adjustments do not supplant a more reliable method and are consistent with the arm's length standard." In other words, the memorandum reads Treas. Reg. section 1.482-4's caution that periodic adjustments "shall be consistent with the arm's length standard" [11] as supplying a presumption that periodic adjustments are arm's length, which can only be rebutted by satisfying one of the relatively narrow exceptions. Yet the traditional reading of that language is that it supplies not a presumption but a requirement that the IRS apply periodic adjustments only when, as a matter of fact, they are consistent with the arm's length standard. The memorandum is difficult to square with the existing regulatory scheme in other ways as well. For example, under Treas. Reg. section 1.482-1, the arm's length standard is to be used "in every case" [12] and the arm's length result "must be" determined by applying the best method. [13] Periodic adjustments are plainly not a "method" within the meaning of the Treasury regulations: taxpayers cannot apply them affirmatively under the regulations, [14] nor are they listed among the enumerated methods under Treas. Reg. sections 1.482-4 and 1.482-7. [15] The IRS' use of periodic adjustments in situations where, as the memorandum contemplates, the taxpayer selected and applied the best method contradicts these foundational regulatory principles.

AM 2025-001 addresses the conflict with the best method rule by stating that the limitation in Treas. Reg. section 1.482-4(a) (i.e., that the specified and unspecified methods applicable to transfers of intangible property must be applied consistent with the general principles of Treas. Reg. section 1.482-1) "does not apply to periodic adjustments." The memorandum concludes that the specific controls over the general, and thus the periodic adjustment rules prevail in the case of a conflict. [16]

AM 2025-001 is notable for its strong embrace of *ex post* data as definitive evidence of appropriate outcomes. The last time Chief Counsel took a public view on this issue was in AM 2007-007, where it concluded that the "better reading" of the 1986 amendment and its legislative history was that *ex post* data gives the IRS "a presumptive basis for making periodic adjustments," subject to rebuttal by the taxpayer. [17] That view is consistent with the Organisation for Economic Co-operation and Development ("OECD") Transfer Pricing Guidelines' guidance on hard-to-value intangibles ("HTVI"), which provides that "*ex post* evidence provides presumptive evidence" but disclaims the use of "*ex post* results for tax assessment purposes without considering whether the information on which the *ex post* results are based could or should reasonably have been known and considered by the associated enterprises at the time the transaction was entered into." [18]

Chief Counsel has now reversed its position and fully embraced the use of *ex post* basis as definitive rather than presumptive evidence, subject to the limited exceptions the regulations provide. This has required a corresponding but subtler reversal of the IRS position regarding consistency with the OECD Guidelines. While AM 2007-007 took the position that the US transfer pricing regulations were "wholly consistent" with the Guidelines, [19] the

corresponding language in AM 2025-001 has softened significantly: "the section 482 regulations (including the periodic adjustment rules) are consistent with the principles of the US's treaty obligations" (but not necessarily with the OECD Guidelines themselves). [20]

Periodic Adjustments and Dispute Resolution

Concerningly, AM 2025-001 directs the US competent authority to "take into account the section 482 regulations (including the periodic adjustment rules) as well as the OECD TPGs (including the HTVI guidance)" when negotiating mutual agreement procedure (MAP) cases pursuant to bilateral tax treaties. [21] As noted, Chief Counsel's interpretation of the periodic adjustment rules is—notwithstanding the memorandum's attempt to provide a gloss of consistency—inconsistent with the OECD's HTVI guidance.

In cases where the IRS proposes periodic adjustments, this could cause difficulty in securing effective competent authority relief, although it is important to bear in mind that the competent authority falls under the control of the IRS Commissioner, and not Chief Counsel. It is therefore hoped that the competent authority will continue to fulfil its treaty obligations and negotiate cases on the basis of the OECD Guidelines, which provide a common and mutually acceptable framework for resolution, rather than insist upon a novel interpretation of domestic regulations that does not accord with international consensus. Even so, difficulties may arise from other sources. The periodic adjustment rules are unusual in that the adjustment falls into a year later—sometimes, much later—than the year in which the transaction occurred. In some cases, intangibles have been transferred to entities that did not originally qualify for treaty relief, and even if the entity qualifies for the adjustment year, obtaining practicable relief may be difficult in these circumstances.

While AM 2025-001 takes the position that periodic adjustments can be applied even if taxpayers do everything correctly, **there is one thing that taxpayers can do to definitively preclude periodic adjustments: obtain an advance pricing agreement ("APA") that provides certainty for the transfer, license, or PCT**. While APAs typically only provide coverage with respect to years formally subject to the agreement, they can also provide ongoing certainty that no periodic adjustment can be made for any future period. [22] **Taxpayers concerned about periodic adjustment exposure—especially in cases where extreme profitability results are foreseeable, however unlikely they may be—should consider seeking certainty through the APA program.**

Actions

As noted above, obtaining an APA to cover the transfer or license can provide legal protection against periodic adjustments for all future years. **Even without an APA, taxpayers have options for reducing periodic adjustment exposure, including via prudent management of contractual terms and true-up payments, as well as developing a strong economic position early on**.

True-Up Mechanisms

Taxpayers entering into agreements governing the transfer or license of IP can include in those agreements a true-up mechanism, but taxpayers should be cautious when evaluating whether it is helpful to do so. Doing so allows the taxpayer to benefit from downward adjustments if projected revenues fail to materialize. To mirror arm's length behavior, such a true-up mechanism would generally be expected to operate in both directions, and to be invoked by either party when it is in that party's interest to do so. Thus, taxpayers that include such a provision in their agreements should monitor how their actual results differ from their projections and be prepared to make periodic adjustments, when warranted, in either direction. Taxpayers should carefully consider how much flexibility to

build into any true-up provision.

Planning a Defense Against Periodic Adjustments

A company should consider affirmatively planning a defense against periodic adjustments at the time of the transfer. Treas. Reg. section 1.482-4(f)(2)(ii)(D)(*1*) provides a limited exception against periodic adjustments if the deviation from expected profits is due to "extraordinary events that were beyond the control of the controlled taxpayers and that could not reasonably have been anticipated at the time the controlled agreement was entered into." However, this exception requires satisfying several other criteria and may be unavailable where the taxpayer enters into a contract allowing for true-ups, unless those true-ups are limited to specified, non-contingent, periodic changes.

There may be significant differences in opinion between the IRS and taxpayers as to what events could "reasonably have been anticipated" at the time of the agreement. Taxpayers could consider a variation of the first recommendation that allows for true-up mechanisms in the event of specific events. For example, the transfer of an early-stage molecule is difficult to value, given that the molecule will have no value if it does not receive Food and Drug Administration (FDA) approval, but could be highly valuable if it eventually becomes a successful drug. Unlike "crown jewel" IP that has often been the target of IRS enforcement effort, transfers of truly unproven IP often occur between third parties (particularly where the inventor does not have the capability to fully develop and commercialize the IP). However, it is almost impossible to predict the potential profits of the IP within the range of accuracy required to avoid periodic adjustments, and under the position taken in AM 2025-001, the IRS would not consider the realization of possible but highly uncertain profits an extraordinary event. In such cases, taxpayers could consider more limited "true-up" payments to be paid between the parties if certain events occur (e.g., approval or non-approval by the FDA). Unlike the true-ups described in the paragraph above, a limited true-up may not bring a taxpayer within the 80%/120% range described in Treas. Reg. section 1.482-4, but may be sufficiently consistent with arm's length results to dissuade the IRS from using the particular arrangement as a test case for the periodic adjustment rules as a practical matter.

Income Attribution and Economic Analysis

It is important to consider that section 482 only provides that the income with respect to the transferred IP be commensurate with the income *attributable to the IP*. In a traditional income method or discounted cash flow analysis, the transferee's projected profits are split between the contributions expected to be made by the transferee (e.g., ongoing development and sales and marketing activities) and the value of the IP that was transferred. Depending on how the transferee's projected contributions are measured, even if actual results are higher than projections, it will often be the case that some of that increase should be attributed to the licensee/transferee (i.e., assuming that the transferee is actually performing value added functions such as developing the market, it should be entitled to some of the upside if profits do end up higher than expected). While Treas. Reg. section 1.482-7 provides mechanical periodic adjustment rules, Treas. Reg. section1.482-4 does not dictate how the transferee's contributions to future profits must be measured. **Taxpayers have an opportunity to stake out a position on this issue. Creating a robust factual and economic analysis prior to an IRS audit can allow the taxpayer to reliably quantify how the difference between actuals and projections should be allocated.**

Resources

- The Commensurate With Income Standard in Transfer Pricing, *Tax Notes International*

(December 16, 2024)

- .OFT file to send to clients regarding the importance of AM 2025-001 – This will be of particular interest to companies that engage in high-value IP transactions (licenses or sales), including CSAs. This is relevant for all levels within an organization, targeted to the VP of tax, head of transfer pricing, tax controversy, international tax planning, and those in the transfer pricing function.

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[1] Pub. L. No. 99-514, Title XII, section 1231(e)(1), 100 Stat. 2562.

[2] Treas. Reg. section 1.482-4(f)(2) (general periodic adjustment rules); Treas. Reg. section 1.482-4(f)(6) (rules for lump sum payments).

[3] Treas. Reg. section 1.482-7(i)(6).

[4] AM 2007-007.

[5] There has not, however, been any formal administrative policy disfavoring or precluding periodic adjustments.

[6] *See* Treas. Reg. section 1.482-4(f)(2)(ii)(B)(4).

[7] AM 2025-001 at 2.

[8] Note, however, that the "extraordinary events" exception under Treas. Reg. section 1.482-4 still requires that the taxpayer satisfy additional requirements under either Treas. Reg. section 1.482-4(2)(ii)(B) or (C). Treas. Reg. section 1.482-4(f)(2)(ii)(D)(2).

[9] AM 2025-001 at 5 n.13.

[10] Notice 88-123.

[11] Treas. Reg. section 1.482-4(f)(2)(i).

[12] Treas. Reg. section 1.482-1(b)(1).

[13] Treas. Reg. section 1.482-1(c)(1).

[14] Treas. Reg. section 1.482-1(a)(3). *See* AM 2025-001 at 3 n.8; *accord* AM 2007-007.

[15] Treas. Reg. section 1.482-4(a); Treas. Reg. section 1.482-7(g)(1).

[16] The memorandum does not address the reasoning of the Ninth Circuit in *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191, 1196 (9th Cir. 2010), which concluded that in the context of section 482, the general principles of Treas. Reg. section 1.482-1 control when contradicted by the specific stock-based compensation guidance at issue in that case. The stock-based compensation rule was a creature of the regulations; CWI is a creature of statute, and as noted above the legislative history is favorable to the government. Inconsistency with the best method rule therefore does not necessarily mean that the taxpayer will win, but it does cloud the question of whether AM 2025-001's stance will withstand scrutiny.

[17] AM 2007-007 at 11.

[18] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ¶ 6.188.

[19] AM 2007-007 at 13.

[20] AM 2025-001 at 12 n.45.

[21] AM 2025-001 at 12 n.45.

[22] Rev. Proc. 2015-41, section 6.03 (“If a covered issue is the transfer of intangible property (which does not constitute a platform contribution transaction as defined in Treas. Reg. section 1.482-7(b)(1)(ii)) within the meaning of Treas. Reg. section1.482-4, the APA may provide that such transfer will not be subject to periodic adjustments, during or after the APA term, under Treas. Reg. section 1.482-4(f)(2) or (6). If a covered issue is a platform contribution transaction, the APA may provide that such transaction will not be treated as a Trigger PCT within the meaning of Treas. Reg. section 1.482-7(i)(6)(i) for purposes of making periodic adjustments, during or after the APA term, under Treas. Reg. section1.482-7(i)(6).”).