

## Section 6662—Imposition of Accuracy-Related Penalty

26 CFR 1.6662-5T: Substantial and gross valuation misstatements under Chapter 1 (Temporary).

T.D. 8656

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: These regulations provide guidance on the imposition of the accuracy related penalty under Internal Revenue Code section 6662(e) for net section 482 transfer price adjustments. This action implements changes to the applicable tax laws made by the Omnibus Budget Reconciliation Act of 1993.

DATES: These regulations are effective February 9, 1996.

Applicability: At the election of the taxpayer, these regulations may be applied to all open taxable years beginning after December 31, 1993.

FOR FURTHER INFORMATION CONTACT: Carolyn D. Fanaroff of the Office of Associate Chief Counsel (International), IRS (202) 622-3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1426. Responses to this collection of information are required by section 6662(e) of the Internal Revenue Code in order to administer the transfer pricing penalty under that section.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated average annual burden per recordkeeper varies from 5 to 15 hours, depending on individual circumstances, with an estimated average of 10 hours per recordkeeper.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books and records relating to this collection of information must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### Background

Sections 6662(e) and (h) of the Internal Revenue Code reflect amendments made by Section 13236 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93, Public Law 103-66, 107 Stat. 312). On February 2, 1994, the IRS and Treasury published temporary regulations (59 FR 4791 [TD 8519, 1994-1 298]) and a notice of proposed rulemaking (58 FR 5263) setting forth rules for imposing a substantial valuation misstatement penalty in connection with transactions between persons described in section 482 (the transactional penalty) and net section 482 transfer price adjustments (the net adjustment penalty) and withdrawing previously proposed regulations issued on January 21, 1993 (58 FR 5304). On July 8, 1994, the IRS and Treasury issued new temporary regulations (59 FR 35030) under section 6662(e) conforming the previously issued regulations to the final 482 regulations published on the same day. A cross-referenced notice of proposed rulemaking accompanied the temporary regulations (59 FR 35066).

The IRS and Treasury received numerous comments on the proposed and temporary regulations from taxpayers, practitioners, tax treaty partners, industry representatives, and professional associations. In general, most commenters recognized the government's interest in encouraging timely compliance

with the arm's length standard at the time that a tax return is filed. These commenters primarily addressed particular aspects of the specified method rule in §1.6662-6(d)(2)(ii) of the temporary regulations that they believed imposed an unnecessary burden.

In response to these comments, the IRS and Treasury have attempted to simplify the requirements set forth in the proposed and temporary regulations without departing from the basic objective of section 6662(e): to improve compliance with the arm's length standard by encouraging taxpayers to make reasonable efforts to determine and document arm's length prices for their intercompany transactions. The regulations are adopted as revised by this Treasury decision, and the corresponding proposed and temporary regulations are removed. Set forth below is a discussion of the most significant comments and the changes made in response to them.

#### Discussion of Major Comments and Changes to the Regulations

##### *The Reasonableness Standard*

Commenters expressed concern that the standard for assertion of the transactional penalty and the net adjustment penalty (together, the penalty) under the proposed and temporary regulations effectively makes the penalty a "no fault" penalty to be imposed in any case in which the statutory thresholds for imposition are met. Commenters suggested that, in all cases, a taxpayer could not have used the most reliable measure of an arm's length result if it subsequently is determined that the taxpayer's analysis was incorrect. Some of these commenters urged the IRS to impose the penalty only where a taxpayer deliberately attempts to shift income.

The IRS and Treasury have determined that it is not necessary to revise the proposed and temporary regulations in response to these comments. The proposed and temporary regulations do not adopt a "no-fault" approach. Like other penalty statutes, the provisions of section 6662(e) incorporate standards of reasonable cause and good faith. See section 6662(e)(3)(D) and section 6664(c). Accordingly, under both the temporary and final regulations, the penalty is excused if the taxpayer, based upon the data that was reason-

ably available to it, reasonably concluded that its analysis was the most reliable and satisfied the documentation requirement of the regulations. In such a case, the taxpayer may be subject to an adjustment if the IRS later employs a different analysis or uses different data leading to a different result, but an adjustment does not necessarily trigger the imposition of the penalty. The regulations provide guidance on the interpretation of the reasonableness standard. See §1.6662-6(d).

### *Reported Results*

In response to comments, the final regulations clarify the method of determining reported results, and what will be considered amended returns for taxpayers electing Accelerated Issue Resolution or similar procedures.

### *Evaluation of Methods Other Than the Method Actually Applied*

Under §1.6662-6T(d)(2)(ii) of the temporary regulations, taxpayers may satisfy the specified method requirement by selecting and applying a specified method in a reasonable manner. In order to meet this requirement, taxpayers must make a reasonable effort to evaluate the potential applicability of the other specified methods in a manner consistent with the principles of the best method rule of §1.482-1(c). Some commenters argued that this requirement would be overly burdensome because it could mean that the taxpayer effectively must disprove all other methods in order to avoid imposition of the penalty. Others asserted that the requirement in §1.6662-6T(d)(2)(ii) that taxpayers make a reasonable effort to evaluate other methods in a manner consistent with the principles of the best method rule was inconsistent with language contained in §1.482-1(c)(1).

The notion of a comparison of methods is inherent in the best method rule of §1.482-1(c)(1). In order to be judged the “best” method, the method to some extent must be compared to other methods. The examples set forth under §1.482-8 illustrate an appropriate application of a comparative analysis. In introducing these examples, §1.482-8 states that “a method may be applied in a particular case only if the comparability, quality of data, and reliability of assumptions under that

method make it more reliable than any other available measure of the arm’s length result.”

The comparison to be done under the best method rule will not necessarily entail a thorough analysis under every potentially applicable method. The nature of the available data will often indicate either that a particular method should be the most reliable or that certain other specified methods would be clearly unreliable. Indeed, in some cases, it might be reasonable to conclude that a particular method is likely to be the most reliable with virtually no consideration of other potentially applicable methods. For example, if the comparable uncontrolled price method can be applied based upon a closely comparable uncontrolled transaction, it normally would be unnecessary to give any serious consideration to the other methods. Whether more extensive consideration could be needed in other cases will depend on the facts and circumstances.

Accordingly, the final regulations retain the notion that comparisons to other specified methods may have to be made and the extent of such comparisons may vary depending upon the data available and other factors.

### *Most Current Data Requirement*

One of the factors taken into account in determining whether a taxpayer reasonably selected and applied a specified method is whether the taxpayer made a reasonable search for data. The proposed and temporary regulations provided that this factor would not be met unless the taxpayer used the most current data that was available prior to filing the tax return. Section 1.6662-6T(d)(2)(iii)(B).

Commenters expressed concern that this requirement would be unduly burdensome because it would require a taxpayer to continually update its transfer pricing analysis until the filing of its tax return. Commenters also argued that this rule could lead to an increased incidence of double taxation if particular foreign jurisdictions did not permit alterations to transactional prices either after the transaction or after the close of a taxable year.

In response to these comments, the requirement to consider the most current available data has been modified. Under the final regulations, taxpayers are expected to use only data available

before the end of the taxable year and consequently have no obligation to continue to search for data after the close of the taxable year to avoid the penalty. However, when a taxpayer obtains additional relevant data between the close of the year and the date on which the tax return is filed (for example, in connection with transfer pricing analyses conducted with respect to the subsequent taxable year), the final regulations require the taxpayer to include such data in its principal documents as provided in §1.6662-6(d)(2)(iii)(B)(9). These documents must be provided to the IRS upon request. These changes are intended to relieve much of the burden on taxpayers and at the same time to ensure that, upon examination, the taxpayer provides the IRS with all relevant information in its possession.

### *Reasonably Thorough Search for Data*

Commenters requested additional guidance regarding the scope of the term *reasonably thorough search for data* under §1.6662-6(d)(2)(ii)(B). The proposed and temporary regulations provide that, in determining whether a search for data was reasonably thorough, the expense of acquiring additional data may be weighed against the dollar amount of the transactions.

The IRS and Treasury have determined that more specific guidelines that would be applicable to all situations cannot be provided because the determination of whether a taxpayer engaged in a reasonable search for data depends on the facts and circumstances of each case. Therefore, the final regulations adhere to the general approach of the proposed and temporary regulations.

However, the final regulations provide a more precise statement of the rule that governs the determination of whether the taxpayer made a reasonable search for data. Section 1.6662-6(d)(2)(ii)(B) of the final regulations provides that taxpayers may weigh the expense a search for data against (i) the likelihood that they will find additional data that will improve the reliability of the results and (ii) the amount by which any new data would change the taxpayer’s taxable income. Thus, a taxpayer that has located reliable data leading to an analysis that is unlikely to become more reliable if additional

data were located would not need to continue a search. In addition, as the amount of taxable income potentially at stake declines (either because of low dollar amounts of the controlled transactions or because of low variability in results that are expected under the facts and circumstances), the need to continue to search for data also decreases.

### *Experience and Knowledge*

Section 1.6662-6(d)(2)(ii)(A) provides that one of the factors taken into account in determining whether a taxpayer reasonably applied a specified method is the experience and knowledge of the taxpayer, including all members of the taxpayer's controlled group. Commenters objected to this factor because it is not limited to consideration of the experience and knowledge of the taxpayer. The purpose of this factor is to consider the experience and knowledge of all the parties that are likely to be involved in the pricing of the controlled transactions. If the scope of this factor were limited to the taxpayer participating in the controlled transaction, the experience and knowledge of related persons who may have had a role in determining intercompany prices of the taxpayer might not be taken into account. Accordingly, this factor has not been changed in the final regulations.

### *Thresholds for Application*

The net adjustment penalty under section 6662(e)(1)(B)(ii) potentially applies if the net section 482 adjustment exceeds the lesser of \$5 million or 10 percent of the taxpayer's gross receipts. Some commenters objected to the statutory \$5 million threshold, pointing out that a relatively insignificant error could easily lead to a \$5 million adjustment with respect to very large intercompany transactions. As a result, taxpayers that made reasonable efforts to determine an arm's length result might nonetheless be subject to penalty.

The \$5 million threshold for imposition of the penalty is fixed by statute. However, §1.6662-6(d)(2)(ii)(G) of the final regulations has been added to provide that the size of an adjustment in relation to the size of the controlled transaction is relevant to determining whether a taxpayer made a reasonable effort to apply a specified or unspec-

ified method. Accordingly, the fact that a proposed adjustment is small in relation to the dollar amount of the controlled transaction to which it relates is relevant in determining if a taxpayer made a reasonable effort to apply a specified or unspecified method.

### *Reliance on Prior Analyses*

Citing the preamble to the temporary regulations and the 1993 legislative history, some commenters requested that a pricing methodology that was approved by the IRS on audit or in connection with an Advanced Pricing Agreement (APA) be considered to satisfy the specified method requirement of the regulations. In response to this comment, §1.6662-6(d)(2)(ii)(F) of the final regulations has been added to provide that whether a taxpayer relied on a methodology developed in connection with an APA or approved by the IRS pursuant to an audit is relevant to determining whether the taxpayer made a reasonable effort to apply a specified or unspecified method, as long as the taxpayer applied the agreed method reasonably and consistently with its prior application, and adjustments have been made for any material changes in the facts and circumstances since the original application of that method. Pursuant to §1.6662-6(d)(3)(ii)(B) and (C), this factor is also relevant if the taxpayer employed an unspecified method.

### *Principal Documents*

Section 1.6662-6(d)(2)(iii)(B) of the final regulations provides a list of principal documents that must be provided to the IRS within 30 days of a request. The proposed and temporary regulations set forth a contemporaneous documentation requirement pursuant to which all of these documents must have been in existence at the time that the taxpayer filed its tax return. In response to comments, several changes have been made to these provisions.

Under the final regulations, the contemporaneous documentation requirement does not apply to the summary of data acquired after the close of the taxable year or the general index of principal and background documents. Thus, these documents do not have to be prepared at the time the return is filed.

Several commenters argued that the requirement that the principal docu-

ments generally be provided within 30 days of a request is too short, but this requirement has not been changed in the final regulations because the statute mandates this 30-day disclosure period. Moreover, except for the two principal documents excluded from the contemporaneous documentation requirement, as described above, all principal documents are required to be prepared by the time the tax return is filed. The IRS and Treasury believe that 30 days should be adequate to provide documents that already exist and that were prepared with the intention of being provided to the IRS.

Other commenters suggested that the list of documents in §1.6662-6(d)(2)-(iii)(B) is too specific and that, in some cases, it should not be necessary to provide all of the documents listed. Some of these commenters suggested that the list of documents be replaced with a more flexible approach under which the documents required would depend on the facts and circumstances.

The final regulations have not been changed in response to this comment. The list of principal documents is intended to provide the IRS with the documents necessary to conduct a complete examination of a taxpayer's transfer pricing. It is anticipated that all of the principal documents listed would be needed in connection with all transfer pricing audits. In addition, the suggested flexible approach would deprive taxpayers and the IRS of much-needed certainty. In the absence of the specific guidance provided by the regulations, most taxpayers would face uncertainty as to the appropriate scope of the documentation requirement.

### *Disclosure of Profit Split, Lump Sum, and Unspecified Methods*

The proposed and temporary regulations require that the taxpayer disclose on its tax return if the taxpayer used a profit split method, an unspecified method, or transferred an intangible in exchange for a lump sum payment. Commenters expressed concern about this requirement, particularly with respect to the profit split method. They asserted that it is inappropriate to impose a penalty on a taxpayer that used a profit split method, solely because it failed to comply with disclosure requirements, if the taxpayer otherwise fully complied with the regulations under section 6662(e). In

response to this comment, the final regulations eliminate the disclosure requirement with respect to the profit split method, lump sum payments, and unspecified methods. The IRS and Treasury believe that these matters are more appropriately addressed under section 6038 and section 6038A of the Internal Revenue Code governing, in part, information returns on Forms 5471 and 5472. The IRS intends to review these forms to determine whether they should be revised.

### Effective Date

These regulations are effective February 9, 1996. However, taxpayers may elect to apply these regulations to all open taxable years beginning after December 31, 1993.

### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to the regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking and temporary regulations preceding these regulations were sent to the Small Business Administration for comment on their impact on small business.

### Drafting Information

The principal author of these regulations is Carolyn D. Fanaroff of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

### PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 is amended by removing the entry

“Sections 1.6662–0 and 1.6662–6T” and adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805. \* \* \*  
Section 1.6662–6 also issued under 26 U.S.C. 6662. \* \* \*

Par. 2. Section 1.6662–0 is amended by:

1. Revising the entry for §1.6662–5T.
2. Adding an entry for §1.6662–6.
3. Removing the entry for §1.6662–6T.

The revisions and additions read as follows:

#### §1.6662–0 Table of contents.

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#### §1.6662–5T Substantial and gross valuation misstatements under chapter 1 (Temporary).

- (a) through (e)(3) [Reserved].
- (e)(4) Tests related to section 481.
  - (i) Substantial valuation statement.
  - (ii) Gross valuation misstatement.
  - (iii) Property.
- (f) through (i) [Reserved].
- (j) Transactions between persons described in section 482 and net section 482 transfer price adjustments.

#### §1.6662–6 Transactions between persons described in section 482 and net section 482 transfer price adjustments.

- (a) In general.
  - (1) Purpose and scope.
  - (2) Reported results.
  - (3) Identical terms used in the section 482 regulations.
- (b) The transactional penalty.
  - (1) Substantial valuation misstatement.
  - (2) Gross valuation misstatement.
  - (3) Reasonable cause and good faith.
- (c) Net adjustment penalty.
  - (1) Net section 482 adjustment.
  - (2) Substantial valuation misstatement.
  - (3) Gross valuation misstatement.
  - (4) Setoff allocation rule.

- (5) Gross receipts.
  - (6) Coordination with reasonable cause exception under section 6664(c).
  - (7) Examples.
- (d) Amounts excluded from net section 482 adjustments.
- (1) In general.
  - (2) Application of a specified section 482 method.
    - (i) In general.
    - (ii) Specified method requirement.
    - (iii) Documentation requirement.
      - (A) In general.
      - (B) Principal documents.
      - (C) Background documents.
  - (3) Application of an unspecified method.
    - (i) In general.
    - (ii) Unspecified method requirement.
      - (A) In general.
      - (B) Specified method potentially applicable.
      - (C) No specified method applicable.
    - (iii) Documentation requirement.
      - (A) In general.
      - (B) Principal and background documents.
  - (4) Certain foreign to foreign transactions.
  - (5) Special rule.
  - (6) Examples.
- (e) Special rules in the case of carrybacks and carryovers.
- (f) Rules for coordinating between the transactional penalty and the net adjustment penalty.
- (1) Coordination of a net section 482 adjustment subject to the net adjustment penalty and a gross valuation misstatement subject to the transactional penalty.
  - (2) Coordination of net section 482 adjustment subject to the net adjustment penalty and substantial valuation misstatements subject to the transactional penalty.
  - (3) Examples.
- (g) Effective date.

Par. 3. Section 1.6662-5T is revised to read as follows:

*§1.6662-5T Substantial and gross valuation misstatements under chapter 1 (Temporary).*

(a) through (e)(3) [Reserved]. For further information, see §1.6662-5(a) through (e)(3).

(e)(4) *Tests related to section 482—*

(i) *Substantial valuation misstatement.* There is a substantial valuation misstatement if there is a misstatement described in §1.6662-6(b)(1) or (c)(1) (concerning substantial valuation misstatements pertaining to transactions between related persons).

(ii) *Gross valuation misstatement.* There is a gross valuation misstatement if there is a misstatement described in §1.6662-6(b)(2) or (c)(2) (concerning gross valuation misstatements pertaining to transactions between related persons).

(iii) *Property.* For purposes of this section, the term *property* refers to both tangible and intangible property. Tangible property includes property such as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action, and any other item of intangible property described in §1.482-4(b).

(f) through (h) [Reserved] For further information, see §1.6662-5(f) through (h).

(i) [Reserved].

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* For rules relating to the penalty imposed with respect to a substantial or gross valuation misstatement arising from a section 482 allocation, see §1.6662-6.

Par. 4. Section 1.6662-6 is added to read as follows:

*§1.6662-6 Transactions between persons described in section 482 and net section 482 transfer price adjustments.*

(a) *In general—(1) Purpose and scope.* Pursuant to section 6662(e) a penalty is imposed on any underpayment attributable to a substantial valuation misstatement pertaining to either a transaction between persons described

in section 482 (the transactional penalty) or a net section 482 transfer price adjustment (the net adjustment penalty). The penalty is equal to 20 percent of the underpayment of tax attributable to that substantial valuation misstatement. Pursuant to section 6662(h) the penalty is increased to 40 percent of the underpayment in the case of a gross valuation misstatement with respect to either penalty. Paragraph (b) of this section provides specific rules related to the transactional penalty. Paragraph (c) of this section provides specific rules related to the net adjustment penalty, and paragraph (d) of this section describes amounts that will be excluded for purposes of calculating the net adjustment penalty. Paragraph (e) of this section sets forth special rules in the case of carrybacks and carryovers. Paragraph (f) of this section provides coordination rules between penalties. Paragraph (g) of this section provides the effective date of this section.

(2) *Reported results.* Whether an underpayment is attributable to a substantial or gross valuation misstatement must be determined from the results of controlled transactions that are reported on an income tax return, regardless of whether the amount reported differs from the transaction price initially reflected in the taxpayer's books and records. The results of controlled transactions that are reported on an amended return will be used only if the amended return is filed before the Internal Revenue Service has contacted the taxpayer regarding the corresponding original return. A written statement furnished by a taxpayer subject to the Coordinated Examination Program or a written statement furnished by the taxpayer when electing Accelerated Issue Resolution or similar procedures will be considered an amended return for purposes of this section if it satisfies either the requirements of §1.6664-2(c)(3) or such requirements as the Commissioner may prescribe by revenue procedure. In the case of a taxpayer that is a member of a consolidated group, the rules of this paragraph (a)(2) apply to the consolidated income tax return of the group.

(3) *Identical terms used in the section 482 regulations.* For purposes of this section, the terms used in this section shall have the same meaning as identical terms used in regulations under section 482.

(b) *The transactional penalty—(1) Substantial valuation misstatement.* In the case of any transaction between related persons, there is a substantial valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct price.

(2) *Gross valuation misstatement.* In the case of any transaction between related persons, there is a gross valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 400 percent or more (or 25 percent or less) of the amount determined under section 482 to be the correct price.

(3) *Reasonable cause and good faith.* Pursuant to section 6664(c), the transactional penalty will not be imposed on any portion of an underpayment with respect to which the requirements of §1.6664-4 are met. In applying the provisions of §1.6664-4 in a case in which the taxpayer has relied on professional analysis in determining its transfer pricing, whether the professional is an employee of, or related to, the taxpayer is not determinative in evaluating whether the taxpayer reasonably relied in good faith on advice. A taxpayer that meets the requirements of paragraph (d) of this section with respect to an allocation under section 482 will be treated as having established that there was reasonable cause and good faith with respect to that item for purposes of §1.6664-4. If a substantial or gross valuation misstatement under the transactional penalty also constitutes (or is part of) a substantial or gross valuation misstatement under the net adjustment penalty, then the rules of paragraph (d) of this section (and not the rules of §1.6664-4) will be applied to determine whether the adjustment is excluded from calculation of the net section 482 adjustment.

(c) *Net adjustment penalty—(1) Net section 482 adjustment.* For purposes of this section, the term *net section 482 adjustment* means the sum of all increases in the taxable income of a taxpayer for a taxable year resulting from allocations under section 482 (determined without regard to any amount carried to such taxable year from another taxable year) less any decreases in taxable income attributable to collateral adjustments as described in §1.482-1(g). For purposes of this section, amounts that meet the require-

ments of paragraph (d) of this section will be excluded from the calculation of the net section 482 adjustment. Substantial and gross valuation misstatements that are subject to the transactional penalty under paragraph (b)(1) or (2) of this section are included in determining the amount of the net section 482 adjustment. See paragraph (f) of this section for coordination rules between penalties.

(2) *Substantial valuation misstatement.* There is a substantial valuation misstatement if a net section 482 adjustment is greater than the lesser of 5 million dollars or ten percent of gross receipts.

(3) *Gross valuation misstatement.* There is a gross valuation misstatement if a net section 482 adjustment is greater than the lesser of 20 million dollars or twenty percent of gross receipts.

(4) *Setoff allocation rule.* If a taxpayer meets the requirements of paragraph (d) of this section with respect to some, but not all of the allocations made under section 482, then for purposes of determining the net section 482 adjustment, setoffs, as taken into account under §1.482-1(g)(4), must be applied ratably against all such allocations. The following example illustrates the principle of this paragraph (c)(4):

*Example.* (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	\$9,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	6,000,000
(3) Because of a setoff under §1.482-1(g)(4)	<u>(5,000,000)</u>
Total section 482 adjustments	10,000,000

(ii) The taxpayer meets the requirements of paragraph (d) with respect to adjustment number one, but not with respect to adjustment number two. The five million dollar setoff will be allocated ratably against the nine million dollar adjustment ( $\$9,000,000/\$15,000,000 \times \$5,000,000 = \$3,000,000$ ) and the six million dollar adjustment ( $\$6,000,000/\$15,000,000 \times \$5,000,000 = \$2,000,000$ ). Accordingly, in determining the net section 482 adjustment, the nine million dollar adjustment is reduced to six million dollars ( $\$9,000,000 - \$3,000,000$ ) and the six million dollar adjustment is reduced to four million dollars ( $\$6,000,000 - \$2,000,000$ ). Therefore, the net section 482 adjustment equals four million dollars.

(5) *Gross receipts.* For purposes of this section, gross receipts must be

computed pursuant to the rules contained in §1.448-1T(f)(2)(iv), as adjusted to reflect allocations under section 482.

(6) *Coordination with reasonable cause exception under section 6664(c).* Pursuant to section 6662(e)(3)(D), a taxpayer will be treated as having reasonable cause under section 6664(c) for any portion of an underpayment attributable to a net section 482 adjustment only if the taxpayer meets the requirements of paragraph (d) of this section with respect to that portion.

(7) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

*Example 1.* (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	\$2,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	2,500,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus markup of a related seller	<u>2,000,000</u>
Total section 482 adjustments	6,500,000

(ii) None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment (\$6.5 million) is greater than five million dollars. Therefore, there is a substantial valuation misstatement.

*Example 2.* (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	\$11,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	2,000,000
(3) Because of a setoff under §1.482-1(g)(4)	<u>(9,000,000)</u>
Total section 482 adjustments	4,000,000

(ii) The taxpayer has gross receipts of sixty million dollars after taking into account all section 482 adjustments. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment (\$4 million) is less than the lesser of five million dollars or ten percent of gross receipts ( $\$60 \text{ million} \times 10\% = \$6 \text{ million}$ ). Therefore, there is no substantial valuation misstatement.

*Example 3.* (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	\$1,500,000
(2) Attributable to Member B	1,000,000
(3) Attributable to Member C	<u>2,000,000</u>
Total section 482 adjustments	4,500,000

(ii) Members A, B, and C have gross receipts of 20 million dollars, 12 million dollars, and 11 million dollars, respectively. Thus, the total gross receipts are 43 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment (\$4.5 million) is greater than the lesser of five million dollars or ten percent of gross receipts ( $\$43 \text{ million} \times 10\% = \$4.3 \text{ million}$ ). Therefore, there is a substantial valuation misstatement.

*Example 4.* (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	\$1,500,000
(2) Attributable to Member B	3,000,000
(3) Attributable to Member C	<u>2,500,000</u>
Total section 482 adjustments	7,000,000

(ii) Members A, B, and C have gross receipts of 20 million dollars, 35 million dollars, and 40 million dollars, respectively. Thus, the total gross receipts are 95 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment (7 million dollars) is greater than the lesser of five million dollars or ten percent of gross receipts ( $\$95 \text{ million} \times 10\% = \$9.5 \text{ million}$ ). Therefore, there is a substantial valuation misstatement.

*Example 5.* (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	\$2,000,000
(2) Attributable to Member B	1,000,000
(3) Attributable to Member C	<u>1,500,000</u>
Total section 482 adjustments	4,500,000

(ii) Members A, B, and C have gross receipts of 10 million dollars, 35 million dollars, and 40 million dollars, respectively. Thus, the total gross receipts are 85 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment (\$4.5 million) is less than the lesser of five million dollars or ten percent of gross receipts ( $\$85 \text{ million} \times 10\% = \$8.5 \text{ million}$ ). Therefore, there is no substantial valuation misstatement even though individual member A's adjustment (\$2 million) is greater than ten percent of its individual gross receipts ( $\$10 \text{ million} \times 10\% = \$1 \text{ million}$ ).

(d) *Amounts excluded from net section 482 adjustments—(1) In general.* An amount is excluded from the calculation of a net section 482 adjustment if the requirements of paragraph (d)(2), (3), or (4) of this section are met with respect to that amount.

(2) *Application of a specified section 482 method—(i) In general.* An amount is excluded from the calculation of a net section 482 adjustment if the taxpayer establishes that both the specified method and documentation requirements of this paragraph (d)(2) are met with respect to that amount. For purposes of this paragraph (d), a method will be considered a specified

method if it is described in the regulations under section 482 and the method applies to transactions of the type under review. A qualified cost sharing arrangement is considered a specified method. See §1.482-7. An unspecified method is not considered a specified method. See §§1.482-3(e) and 1.482-4(d).

(ii) *Specified method requirement.* The specified method requirement is met if the taxpayer selects and applies a specified method in a reasonable manner. The taxpayer's selection and application of a specified method is reasonable only if, given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule of §1.482-1(c). A taxpayer can reasonably conclude that a specified method provided the most reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods in a manner consistent with the principles of the best method rule. The extent of this evaluation generally will depend on the nature of the available data, and it may vary from case to case and from method to method. This evaluation may not entail an exhaustive analysis or detailed application of each method. Rather, after a reasonably thorough search for relevant data, the taxpayer should consider which method would provide the most reliable measure of an arm's length result given that data. The nature of the available data may enable the taxpayer to conclude reasonably that a particular specified method provides a more reliable measure of an arm's length result than one or more of the other specified methods, and accordingly no further consideration of such other specified methods is needed. Further, it is not necessary for a taxpayer to conclude that the selected specified method provides a more reliable measure of an arm's length result than any unspecified method. For examples illustrating the selection of a specified method consistent with this paragraph (d)(2)(ii), see §1.482-8. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this determination include the following:

(A) The experience and knowledge of the taxpayer, including all members of the taxpayer's controlled group.

(B) The extent to which reliable data was available and the data was analyzed in a reasonable manner. A taxpayer must engage in a reasonably thorough search for the data necessary to determine which method should be selected and how it should be applied. In determining the scope of a reasonably thorough search for data, the expense of additional efforts to locate new data may be weighed against the likelihood of finding additional data that would improve the reliability of the results and the amount by which any new data would change the taxpayer's taxable income. Furthermore, a taxpayer must use the most current reliable data that is available before the end of the taxable year in question. Although the taxpayer is not required to search for relevant data after the end of the taxable year, the taxpayer must maintain as a principal document described in paragraph (d)(2)(iii)(B)(9) of this section any relevant data it obtains after the end of the taxable year but before the return is filed, if that data would help determine whether the taxpayer has reported its true taxable income.

(C) The extent to which the taxpayer followed the relevant requirements set forth in regulations under section 482 with respect to the application of the method.

(D) The extent to which the taxpayer reasonably relied on a study or other analysis performed by a professional qualified to conduct such a study or analysis, including an attorney, accountant, or economist. Whether the professional is an employee of, or related to, the taxpayer is not determinative in evaluating the reliability of that study or analysis, as long as the study or analysis is objective, thorough, and well reasoned. Such reliance is reasonable only if the taxpayer disclosed to the professional all relevant information regarding the controlled transactions at issue. A study or analysis that was reasonably relied upon in a prior year may reasonably be relied upon in the current year if the relevant facts and circumstances have not changed or if the study or analysis has been appropriately modified to reflect any change in facts and circumstances.

(E) If the taxpayer attempted to determine an arm's length result by using more than one uncontrolled comparable, whether the taxpayer arbitrarily selected a result that corresponds to an extreme point in the

range of results derived from the uncontrolled comparables. Such a result generally would not likely be closest to an arm's length result. If the uncontrolled comparables that the taxpayer uses to determine an arm's length result are described in §1.482-1(e)(2)-(ii)(B), one reasonable method of selecting a point in the range would be that provided in §1.482-1(e)(3).

(F) The extent to which the taxpayer relied on a transfer pricing methodology developed and applied pursuant to an Advance Pricing Agreement for a prior taxable year, or specifically approved by the Internal Revenue Service pursuant to a transfer pricing audit of the transactions at issue for a prior taxable year, provided that the taxpayer applied the approved method reasonably and consistently with its prior application, and the facts and circumstances surrounding the use of the method have not materially changed since the time of the IRS's action, or if the facts and circumstances have changed in a way that materially affects the reliability of the results, the taxpayer makes appropriate adjustments to reflect such changes.

(G) The size of a net transfer pricing adjustment in relation to the size of the controlled transaction out of which the adjustment arose.

(iii) *Documentation requirement—*  
(A) *In general.* The documentation requirement of this paragraph (d)(2)(iii) is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most accurate measure of an arm's length result under the principles of the best method rule in §1.482-1(c), and provides that documentation to the Internal Revenue Service within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates. With the exception of the documentation described in paragraphs (d)(2)(iii)(B)(9) and (10) of this section, that documentation must be in existence when the return is filed. The district director may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known. The required documentation is divided into two categories, principal

documents and background documents as described in paragraphs (d)(2)(iii)(B) and (C) of this section.

(B) *Principal documents.* The principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. The documentation must include the following—

(1) An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;

(2) A description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;

(3) Any documentation explicitly required by the regulations under section 482;

(4) A description of the method selected and an explanation of why that method was selected;

(5) A description of the alternative methods that were considered and an explanation of why they were not selected;

(6) A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions. For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity;

(7) A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;

(8) An explanation of the economic analysis and projections relied upon in developing the method. For example, if a profit split method is applied, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits would be split;

(9) A description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and

(10) A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

(C) *Background documents.* The assumptions, conclusions, and positions contained in principal documents ordinarily will be based on, and supported by, additional background documents. Documents that support the principal documentation may include the documents listed in §1.6038A-3(c) that are not otherwise described in paragraph (d)(2)(iii)(B) of this section. Every document listed in those regulations may not be relevant to pricing determinations under the taxpayer's specific facts and circumstances and, therefore, each of those documents need not be maintained in all circumstances. Moreover, other documents not listed in those regulations may be necessary to establish that the taxpayer's method was selected and applied in the way that provided the most accurate measure of an arm's length result under the principles of the best method rule in §1.482-1(c). Background documents need not be provided to the Internal Revenue Service in response to a request for principal documents. If the Internal Revenue Service subsequently requests background documents, a taxpayer must provide that documentation to the Internal Revenue Service within 30 days of the request. However, the district director may, in his discretion, extend the period for producing the background documentation.

(3) *Application of an unspecified method*—(i) *In general.* An adjustment is excluded from the calculation of a net section 482 adjustment if the taxpayer establishes that both the unspecified method and documentation requirements of this paragraph (d)(3) are met with respect to that amount.

(ii) *Unspecified method requirement*—(A) *In general.* If a method other than a specified method was applied, the unspecified method requirement is met if the requirements of paragraph (d)(3)(ii)(B) or (C) of this section, as appropriate, are met.

(B) *Specified method potentially applicable.* If the transaction is of a type for which methods are specified in the regulations under section 482, then a taxpayer will be considered to have met the unspecified method requirement if the taxpayer reasonably con-

cludes, given the available data, that none of the specified methods was likely to provide a reliable measure of an arm's length result, and that it selected and applied an unspecified method in a way that would likely provide a reliable measure of an arm's length result. A taxpayer can reasonably conclude that no specified method was likely to provide a reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the specified methods in a manner consistent with the principles of the best method rule. However, it is not necessary for a taxpayer to conclude that the selected method provides a more reliable measure of an arm's length result than any other unspecified method. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this conclusion include those set forth in paragraph (d)(2)(ii) of this section.

(C) *No specified method applicable.* If the transaction is of a type for which no methods are specified in the regulations under section 482, then a taxpayer will be considered to have met the unspecified method requirement if it selected and applied an unspecified method in a reasonable manner. For purposes of this paragraph (d)(3)(ii)(C), a taxpayer's selection and application is reasonable if the taxpayer reasonably concludes that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule in §1.482-1(c). However, it is not necessary for a taxpayer to conclude that the selected method provides a more reliable measure of an arm's length result than any other unspecified method. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this conclusion include those set forth in paragraph (d)(2)(ii) of this section.

(iii) *Documentation requirement*—(A) *In general.* The documentation requirement of this paragraph (d)(3) is met if the taxpayer maintains sufficient documentation to establish that the unspecified method requirement of paragraph (d)(3)(ii) of this section is met and provides that documentation to the Internal Revenue Service within 30 days of a request for it. That documentation must be in existence when the return is filed. The district director



may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known.

(B) *Principal and background documents.* See paragraphs (d)(2)(iii)(B) and (C) of this section for rules regarding these two categories of required documentation.

(4) *Certain foreign to foreign transactions.* For purposes of calculating a net section 482 adjustment, any increase in taxable income resulting from an allocation under section 482 that is attributable to any controlled transaction solely between foreign corporations will be excluded unless the treatment of that transaction affects the determination of either corporation's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(5) *Special rule.* If the regular tax (as defined in section 55(c)) imposed on the taxpayer is determined by reference to an amount other than taxable income, that amount shall be treated as the taxable income of the taxpayer for purposes of section 6662(e)(3). Accordingly, for taxpayers whose regular tax is determined by reference to an amount other than taxable income, the increase in that amount resulting from section 482 allocations is the taxpayer's net section 482 adjustment.

(6) *Examples.* The principles of this paragraph (d) are illustrated by the following examples:

*Example 1.* (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	\$9,000,000
(2) Not a 200 percent or 400 percent adjustment	2,000,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus markup of a related seller	<u>9,000,000</u>
Total section 482 adjustments	<u>20,000,000</u>

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. The taxpayer establishes that for adjustments number one and three, it applied a transfer pricing method specified in section 482, the selection and application of the method was reasonable, it documented the pricing analysis, and turned that documentation over to the IRS

within 30 days of a request. Accordingly, eighteen million dollars is excluded from the calculation of the net section 482 adjustment. Because the net section 482 adjustment is two million dollars, there is no substantial valuation misstatement.

*Example 2.* (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	\$9,000,000
(2) Attributable to an adjustment that is 200 percent or more of the correct section 482 price	2,000,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus markup of a related seller	<u>9,000,000</u>
Total section 482 adjustments	<u>20,000,000</u>

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. The taxpayer establishes that for adjustments number one and three it applied a transfer pricing method specified in section 482, the selection and application of the method was reasonable, it documented that analysis, and turned the documentation over to the IRS within 30 days. Accordingly, eighteen million dollars is excluded from the calculation of the section 482 transfer pricing adjustments for purposes of applying the five million dollar or 10% of gross receipts test. Because the net section 482 adjustment is only two million dollars, the taxpayer is not subject to the net adjustment penalty. However, the taxpayer may be subject to the transactional penalty on the underpayment of tax attributable to the two million dollar adjustment.

*Example 3.* CFC1 and CFC2 are controlled foreign corporations within the meaning of section 957. Applying section 482, the IRS disallows a deduction for 25 million dollars of the interest that CFC1 paid to CFC2, which results in CFC1's U.S. shareholder having a subpart F inclusion in excess of five million dollars. No other adjustments under section 482 are made with respect to the controlled taxpayers. However, the increase has no effect upon the determination of CFC1's or CFC2's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States. Accordingly, there is no substantial valuation misstatement.

(e) *Special rules in the case of carrybacks and carryovers.* If there is a substantial or gross valuation misstatement for a taxable year that gives rise to a loss, deduction or credit that is carried to another taxable year, the transactional penalty and the net adjustment penalty will be imposed on any resulting underpayment of tax in that other taxable year. In determining whether there is a substantial or gross valuation misstatement for a taxable year, no amount carried from another taxable year shall be included. The following example illustrates the principle of this paragraph (e):

*Example.* The Internal Revenue Service makes a section 482 adjustment of six million dollars in taxable year 1, no portion of which is excluded under paragraph (d) of this section. The taxpayer's income tax return for year 1 reported a loss of three million dollars, which was carried to taxpayer's year 2 year income tax return and used to reduce income taxes otherwise due with respect to year 2. A determination is made that the six million dollar allocation constitutes a substantial valuation misstatement, and a penalty is imposed on the underpayment of tax in year 1 attributable to the substantial valuation misstatement and on the underpayment of tax in year 2 attributable to the disallowance of the net operating loss in year 2. For purposes of determining whether there is a substantial or gross valuation misstatement for year 2, the three million dollar reduction of the net operating loss will not be added to any section 482 adjustments made with respect to year 2.

(f) *Rules for coordinating between the transactional penalty and the net adjustment penalty—(1) Coordination of a net section 482 adjustment subject to the net adjustment penalty and a gross valuation misstatement subject to the transactional penalty.* In determining whether a net section 482 adjustment exceeds five million dollars or 10 percent of gross receipts, an adjustment attributable to a substantial or gross valuation misstatement that is subject to the transactional penalty will be taken into account. If the net section 482 adjustment exceeds five million dollars or ten percent of gross receipts, any portion of such amount that is attributable to a gross valuation misstatement will be subject to the transactional penalty at the forty percent rate, but will not also be subject to net adjustment penalty at a twenty percent rate. The remaining amount is subject to the net adjustment penalty at the twenty percent rate, even if such amount is less than the lesser of five million dollars or ten percent of gross receipts.

(2) *Coordination of net section 482 adjustment subject to the net adjustment penalty and substantial valuation misstatements subject to the transactional penalty.* If the net section 482 adjustment exceeds twenty million dollars or 20 percent of gross receipts, the entire amount of the adjustment is subject to the net adjustment penalty at a forty percent rate. No portion of the adjustment is subject to the transactional penalty at a twenty percent rate.

(3) *Examples.* The following examples illustrate the principles of this paragraph (f):

*Example 1.* (i) Applying section 482, the Internal Revenue Service makes the following adjustments for the taxable year:

(1) Attributable to an adjustment that is 400 percent or more of the correct section 482 arm's length result	\$2,000,000
(2) Not a 200 or 400 percent adjustment	<u>2,500,000</u>
Total	4,500,000

(1) Attributable to an adjustment that is 400 percent or more of the correct section 482 arm's length result	\$6,000,000
(2) Not a 200 or 400 percent adjustment	<u>15,000,000</u>
Total	21,000,000

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. None of the adjustments is excluded under paragraph (d) (Amounts excluded from net section 482 adjustments) of this section, in determining the five million dollar or 10% of gross receipts test under section 6662(e)-(1)(B)(ii). The net section 482 adjustment (4.5 million dollars) is less than the lesser of five million dollars or ten percent of gross receipts (\$75 million  $\times$  10% = \$7.5 million). Thus, there is no substantial valuation misstatement. However, the two million dollar adjustment is attributable to a gross valuation misstatement. Accordingly, the taxpayer may be subject to a penalty, under section 6662(h), equal to 40 percent of the underpayment of tax attributable to the gross valuation misstatement of two million dollars. The 2.5 million dollar adjustment is not subject to a penalty under section 6662(b)(3).

*Example 2.* The facts are the same as in *Example 1*, except the taxpayer has gross receipts of 40 million dollars. The net section 482 adjustment (\$4.5 million) is greater than the lesser of five million dollars or ten percent of gross receipts (\$40 million  $\times$  10% = \$4 million). Thus, the five million dollar or 10% of gross receipts test has been met. The two million dollar adjustment is attributable to a gross valuation misstatement. Accordingly, the taxpayer is subject to a penalty, under section 6662(h), equal to 40 percent of the underpayment of tax attributable to the gross valuation misstatement of two million dollars. The 2.5 million dollar adjustment is subject to a penalty under sections 6662(a) and 6662(b)(3), equal to 20 percent of the underpayment of tax attributable to the substantial valuation misstatement.

*Example 3.* (i) Applying section 482, the Internal Revenue Service makes the following transfer pricing adjustments for the taxable year:

(ii) None of the adjustments are excluded under paragraph (d) (Amounts excluded from net section 482 adjustments) in determining the twenty million dollar or 20% of gross receipts test under section 6662(h). The net section 482 adjustment (21 million dollars) is greater than twenty million dollars and thus constitutes a gross valuation misstatement. Accordingly, the total adjustment is subject to the net adjustment penalty equal to 40 percent of the underpayment of tax attributable to the 21 million dollar gross valuation misstatement. The six million dollar adjustment will not be separately included for purposes of any additional penalty under section 6662.

(g) *Effective date.* This section is effective February 9, 1996. However, taxpayers may elect to apply this section to all open taxable years beginning after December 31, 1993.

### **\$1.6662-6T [Removed]**

Par. 5. Section 1.6662-6T is removed.

Par. 6a. In §1.6664-0, the introductory text is amended by removing the reference “1.6664-4” and adding “1.6664-4T” in its place.

Par. 6b. Section 1.6664-4T is revised to read as follows:

*§1.6664-4T Reasonable cause and good faith exception to section 6662 penalties.*

(a) through (e) [Reserved].

(f) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* For purposes of applying the reasonable

cause and good faith exception of section 6664(c) to net section 482 adjustments, the rules of §1.6662-6(d) apply. A taxpayer that does not satisfy the rules of §1.6662-6(d) for a net section 482 adjustment cannot satisfy the reasonable cause and good faith exception under section 6664(c). The rules of this section apply to underpayments subject to the transactional penalty in §1.6662-6(b). If the standards of the net section 482 penalty exclusion provisions under §1.6662-6(d) are met with respect to such underpayments, then the taxpayer will be considered to have acted with reasonable cause and good faith for purposes of this section.

### **PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT**

Par. 7. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 8. In §602.101, paragraph (c) is amended by removing the entry for §1.6662-6T from the table and adding an entry in numerical order to the table to read “1.6662-6.... 1545-1426”.

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*

Approved January 19, 1996.

Leslie Samuels,  
*Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on February 8, 1996, 8:45 a.m., and published in the issue of the Federal Register for February 9, 1996, 61 F.R. 4876)