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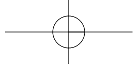

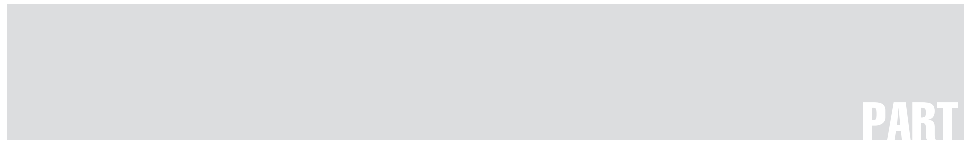

PART one

Understanding Transfer Pricing

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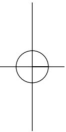

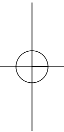

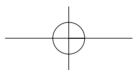

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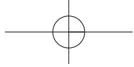

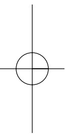

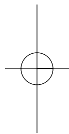

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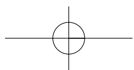

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CHAPTER 1

Practical Aspects of Transfer Pricing

By Robert Feinschreiber

Transfer pricing, for tax purposes, is the pricing of intercompany transactions that take place between affiliated businesses. The transfer pricing process determines the amount of income that each party earns from that transaction. Taxpayers and the taxing authorities focus exclusively on related-party transactions, which are termed *controlled transactions*, and have no direct impact on independent-party transactions, which are termed *uncontrolled transactions*. Transactions, in this context, are determined broadly, and include sales, licensing, leasing, services, and interest.

The concept of an international corporate headquarters of a multinational corporation that uses transfer pricing to minimize worldwide taxation is no longer viable. Two impediments limit the use of transfer pricing to achieve tax minimization: (1) the tax authorities are intent on their own revenue maximization by thwarting the taxpayer's tax minimization plans, and (2) nontax considerations may be more significant in taxation than taxation.

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COMPARISON OR DIVISION

Section 482 of the Internal Revenue Code (IRC) was finalized in July 1994.[1] Section 482 provides two approaches to transfer pricing:

1. Dividing the total income from the transaction between related parties
2. Comparing controlled transactions with uncontrolled transactions

Of the two methods set forth, these regulations prefer that transfer pricing be based on the comparison of transactions method rather than the division of income approach.

[1] (TD 8552) 59 FR 34971 (July 8, 1994).

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RELATIONSHIP OF THE PARTIES

The relationship between parties to a transaction affects the way in which transfer pricing is determined. The transfer pricing regulations recognize three relationships:

1. Both parties to the transaction are controlled, as in a sale between a U.S. subsidiary and a foreign subsidiary of the parent company.
2. One party to the transaction is controlled, the other party is uncontrolled, as in a sale between a U.S. subsidiary of a parent company and an unaffiliated company.
3. Neither party is controlled, as when the transaction is wholly independent from the taxpayer's activities.

The transfer pricing regulations suggest that a taxpayer compare its totally controlled transactions with transactions between a controlled party and an uncontrolled party. The regulations generally do not favor the comparison of wholly independent transactions to determine price. The primary thrust of the transfer pricing regulations is a comparison between wholly controlled transactions with transactions between a controlled party and uncontrolled parties, which are often referred to as in-house comparables.[2]

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OVERVIEW OF THE TAX CHANGES

The regulations fundamentally change the way in which the taxpayer and the IRS determine transfer pricing. Before the regulations came into effect, the IRS could challenge a taxpayer's transfer price as not arm's length, and the IRS could then assert a specific transfer price that it believed was arm's length. The IRS was frequently defeated in court when it challenged the taxpayer and asserted its own transfer pricing method. Faced with prior IRS defeats, the regulations permit the taxpayer to use a range of transfer prices but expect the taxpayer to develop its transfer pricing methodology in advance.[3]

The IRS will accept the taxpayer's transfer pricing as arm's length if the price is within a range of arm's-length prices; however, the taxpayer should not expect much solace from the IRS. The IRS now may be able to move the range of acceptable prices or truncate the transfer pricing range. Moreover, the taxpayer's pricing decisions could be subject to an extensive penalty regime. A taxpayer that chooses the inappropriate transfer pricing method is subject to penalties, but a taxpayer can avoid sanctions if it prepares contemporaneous documentation that substantiates its transfer pricing methodology.[4]

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[2] Treas. Reg. §§ 1.482-3(c)(3)(ii)(A) and 1.482-3(d)(3)(ii)(A).
[3] Preamble to the 1994 transfer pricing regulations.
[4] Treas. Reg. § 1.6662-6(d)(2)(iii).

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Under the prior transfer pricing regulations, taxpayers were not required to substantiate their transfer pricing decisions, whether at the time the tax return was filed or during the prior taxable year. The taxpayer merely second guessed the IRS's adjustments if they were proposed. The order is now reversed: First the taxpayer must substantiate its pricing, and then the IRS can challenge the taxpayer's approach. Once the taxpayer is locked in to its transfer pricing method, it is precluded from challenging the IRS's approach by suggesting a different method. The taxpayer, forced to select a transfer pricing method before the transaction, is analogous to a person who must attempt to hit a moving target while blindfolded.

APPROACHES TO TRANSFER PRICING

Taxation that is based on transfer pricing is becoming an important issue for many companies, whether U.S. based or foreign based. The regulations have sought to impose extensive general principles and guidelines that apply when the taxpayer selects the transfer pricing method.[5] These methods impose penalties on an inappropriate choice of a transfer pricing method. In addition, the administrative cost of complying with the regulations can be extensive. As a result, implementation of the transfer pricing regulations may impose significant costs on the taxpayer above and beyond the taxes themselves.

Faced with this transfer pricing onslaught, businesses have chosen different approaches to the tax aspects of transfer pricing. At the outset, the selection of a transfer pricing strategy is determined by three factors:

1. Taxes imposed on the transfer pricing decision
2. Administrative time and expense incurred
3. Potential penalties (which are discussed next)

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PENALTIES

The presence or absence of a potential penalty may determine a taxpayer's transfer pricing policy. If the effective tax rates in both jurisdictions are equal, including withholding tax, and there are no impediments to obtaining the foreign tax credit, the multijurisdictional taxpayer might have no tax incentive to adjust transfer pricing apart from the risk of IRS penalties. Nontax factors, such as tariffs and unemployment compensation, may determine transfer pricing policy but are not discussed here.

Two types of penalties can be imposed on transfer pricing adjustments:[6]

1. Substantial valuation misstatement
2. Gross valuation misstatement

[5] Treas. Reg. § 1.482-1(a)(1).
[6] Treas. Reg. § 1.6662-6(b).

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The two penalties are of the same type but differ in magnitude. The substantial valuation misstatement penalty is 20 percent of the tax; the gross valuation misstatement penalty is 40 percent of the tax. Regardless of the magnitude of the misstatement, there are two types of penalty:

1. Transactional
2. Net 482 adjustment

There are four types of transfer pricing penalties:

1. Transactional penalty: substantial valuation misstatement
2. Transactional penalty: gross valuation misstatement
3. Net 482 adjustment: substantial valuation misstatement
4. Net 482 adjustment: gross valuation misstatement

Transactional Penalty

A *substantial valuation misstatement* penalty applies to a taxpayer who uses unnecessarily high or low valuations. A *gross valuation misstatement* penalty applies to a taxpayer who uses more extreme low valuations or more extreme high valuations.

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High Valuation—Substantial Valuation Misstatement The substantial valuation misstatement penalty applies if the price paid for "any property or services (or for the use of property)," as claimed by the taxpayer on the tax return, is 200 percent or more of the "amount determined under Section 482 to be the correct price." For example, a taxpayer charges Affiliate A $4,000 for services. It is determined that "the correct price" is $1,800. The substantial valuation misstatement penalty applies.

Low Valuation—Substantial Valuation Misstatement The substantial valuation misstatement penalty applies if the price paid for "any property or services (or for the use of property)," as claimed by the taxpayer on the tax return, is 50 percent or less of the "amount determined under Section 482 to be the correct price." For example, a taxpayer charges Affiliate B $4,000 for services. It is determined that "the correct price" is $8,200. The substantial valuation misstatement penalty applies.

High Valuation—Gross Valuation Misstatement The gross valuation misstatement penalty applies if the price paid for "any property or services (or for the use of property)," as claimed by the taxpayer on the tax return, is 400 percent or more of the "amount determined under Section 482 to be the correct price." For example, a taxpayer charges Affiliate C $4,000 for services. It is determined that "the correct price" is $800. The gross valuation misstatement penalty applies.

Low Valuation—Gross Valuation Misstatement The gross valuation misstatement penalty applies if the price paid for "any property or services (or for the use of property)," as claimed by the taxpayer on the tax return, is 25 percent or less of the "amount determined under Section 482 to be the correct price." For example, a tax-

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payer charges Affiliate D $4,000 for services. It is determined that "the correct price" is $16,200. The gross valuation misstatement penalty applies.

Net Adjustment Penalty

The *net adjustment penalty* is based on "net Section 482 adjustments," which are the sum of all increases in taxable income less any decreases in taxable income.[7] Increases are counted to determine the net adjustment if they result "from allocations under Section 482." Decreases are counted to determine the net adjustment if the decreases are attributable collateral adjustments. Thus it is contemplated that positive adjustments will exceed negative adjustments by a wide margin.

Substantial Valuation Adjustment A *substantial valuation penalty* applies if a net 482 adjustment exceeds either of two thresholds:

1. $5 million
2. 10 percent of gross receipts

The lower of the two amounts determines whether the substantial valuation penalty applies. If a company has gross receipts of less than $50 million, the threshold is 10 percent of gross receipts. If the company has gross receipts of $50 million or more, the threshold is $5 million. For example, Company X has gross receipts of $40 million. A Section 482 adjustment was 4.5 million for example, income of $1.5 was adjusted to $6 million. The adjustment of $4.5 million exceeds 10 percent of gross receipts or $4 million, so the substantial valuation misstatement penalty applies.

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Gross Valuation Misstatement A *gross valuation misstatement penalty* applies if a net 482 adjustment exceeds either of two thresholds:

1. $20 million
2. 20 percent of gross receipts

The lower of the two amounts determines whether the gross valuation misstatement penalty applies. If a company has gross receipts of less than $100 million, the threshold is 20 percent of gross receipts. If a company has gross receipts of $100 million or more, the threshold is $20 million. For example, Company Y has gross receipts of $80 million. A Section 482 adjustment was $17 million; for example, income of $3 million was adjusted to $20 million. The adjustment of $17 million exceeds 20 percent of gross receipts or $16 million, so the gross valuation misstatement penalty applies.

Avoiding the Penalty

The transfer pricing penalty can be avoided in limited circumstances. The regulations specify two methods:[8]

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[7] Treas. Reg. § 1.6662-6(b).

[8] Treas. Reg. § 1.6662-6(d)(1).

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1. By demonstrating reasonable cause and good faith, but only as to the transactional penalty
2. By complying with the specific method requirement and the documentation requirement

TRANSFER PRICING STRATEGIES

Many transfer pricing strategies are available. Before you dwell on the morass of new transfer pricing tax rules in depth, it might be advantageous for you to assess where your company fits, or should fit, in the spectrum of strategies.

Head in the Sand Approach

One approach to transfer pricing is to do nothing, stand pat. As one taxpayer stated, "We have some sand, and we're looking for an ostrich. We don't understand the tax rules, and neither does the IRS. We don't want to rock the boat, or provide the IRS with a roadmap to our company with the documentation we prepare. The preamble to the new transfer pricing regulations says that the 'estimated average annual burden per recordkeeper is 0.8 hours,' and we will be devoting just that amount, 48 minutes per year, to transfer pricing."

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Comprehensive Analysis Approach

Some companies are implementing a full-blown comprehensive approach to transfer pricing, creating and developing a team of decision makers and other resource people, both within and without the company itself. More than 30 categories of professionals could be included in the transfer pricing team, including the following:

- *Accountants*
  - *Accounts payable accountants.* To review credit and collection strategies, a process needed to compare transactions
  - *Controllers.* Operations executives providing the database to develop and defend transfer pricing
  - *Cost accountants.* To develop the bulwark of the database needed to apply the resale price method or the cost plus method
  - *Financial accountants.* Using FAS and SEC accounting rules to prepare a database needed for comparative purposes
  - *Tax accountants.* To prepare the documentation for the tax return
- *Attorneys*
  - *Contract attorneys.* An analysis of contracts and terms is mandatory for transfer pricing purposes.
  - *Customs attorneys.* The cost of tariffs and tax costs should be considered together for transfer pricing purposes.

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  - *Intellectual property attorneys.* Ascertaining the scope of intangible property may be significant; licensing is an important facet of transfer pricing.
  - *Litigation attorneys.* Discovery procedures and confidentiality are needed long before litigation is contemplated.
  - *Tax attorneys.* Interface between the other attorneys and the accountants
  - *Trade attorneys.* Countervailing duties and dumping should be considered together with taxation.

- ***Computer programmers.*** To implement record retention and prepare analytical reports
- ***Customs specialists.*** Customs documentation is important evidence for tax purposes.
- ***Economists***

  - *Economic geographers.* To prepare analysis between countries, sometimes needed for comparative purposes
  - *Microeconomists.* Difference analysis is at the heart of transfer pricing analysis, preparing the viability of comparable transactions
  - *Macroeconomists.* To select the database; to cope with business cycles as they affect transfer pricing

- ***Employee benefits specialists.*** Fringe benefits might affect costing to determine the gross profit markup or gross profit.
- ***Engineers***

  - *Engineering economists.* To interface between production engineers and process engineers and economists
  - *Production engineers.* To determine functions of the company
  - *Process engineers.* To determine functional analysis

- ***Financial analysts.*** To review financial reporting prepared by the company's competitors, to determine comparable ratios
- ***Industry specialists.*** Persons who know what is going on in the industry, developing market share analysis
- ***Marketing specialists.*** To assess the advertising, marketing, and sales functions of the company
- ***Mathematical statisticians.*** To determine the relevant range of transactions for comparability analysis
- ***Personnel.*** To obtain job descriptions needed to determine functions performed
- ***Operational analysts.*** Developing procedures that explain how the company works
- ***Risk analysts.*** To prepare the mandatory analysis of risk and exposure
- ***Tax specialists***

  - *International tax specialists.* Interrelationship with foreign tax credit, allocation and apportionment procedures, foreign sales corporation, foreign reporting procedures in the United States, reporting of income to foreign jurisdictions

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  - *State tax specialists.* States can impose transfer pricing rules; coordination of federal and state rules may be needed.
  - *Foreign tax specialists.* Foreign taxes are essential to the overall transfer pricing equation.
- ***Treasurer.*** Prepare international currency and hedging analysis, which is required under the tax rules

PARAMETERS TO SUBSTANTIATING TRANSFER PRICING

Your company might not fit into either of the two extremes of the head in the sand approach or the comprehensive analysis approach. The approach of one size fits all does not appear to be viable for the tax facets of transfer pricing. Instead, your company's approach may depend on the size of the business, certain empirical ratios, and other criteria. The following parameters pertaining to business size, profitability, international ratios, and other criteria should be helpful.

Business Size

Revenue, income, and assets are factors that could be relevant in assessing the depth and magnitude of your company's transfer pricing approach, including the following facets:

- Total worldwide sales
- Total worldwide income
- Sales in the United States
- Income from sales in the United States
- Imports to the United States
- Income from imports to the United States
- Intercompany sales—imports and exports
- Income attributable to intercompany sales
- U.S. assets
- Worldwide assets

In general, the higher the magnitude of these numbers, the more likely it is that the company should consider the comprehensive analysis approach. Consider the following:

- The temporary regulations, which are no longer applicable, provided a safe harbor based on $10 million in sales.
- One important penalty applies to adjustments in transfer price of $5 million or more; this penalty could affect a company with revenues of $100 million having profits of $20 million, and having an adjustment of one-quarter of the $20 million profit amount. The penalty issues were discussed previously.

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- The contemporaneous documentation transfer pricing regulations refer to the tax reporting rules for foreign-owned U.S. corporations. The tax reporting rules have their own size criteria.[9]
  - $50,000, the small amount threshold for reporting an amount on Form 5472
  - $5 million, a gross payments threshold that excuses related-party transactions
  - $10 million, a U.S. gross receipts threshold that excuses small corporations
  - $20 million, a gross receipts threshold that might excuse the taxpayer from the penalty
  - $25 million, a gross revenue threshold [U.S.-connected products or services (export and import) of $25 million] that requires the taxpayer to produce data from each significant industry segment
  - $100 million, a gross revenue threshold that requires the taxpayer to produce more information, whether or not the segment is significant

Profitability Ratios

A company may find it advantageous to devote more effort to establishing and reviewing transfer pricing when a profitability factor or similar ratio is high and to curtail transfer pricing efforts when these factors are low. Here, high profitability might be 15 percent, using the high-profit test within the foreign reporting regulations, which relies on the return on assets. The transfer pricing methods provide for the comparable profits method, and the taxpayer should consider its three methods in deciding upon the level of effort it should undertake. These ratios are the final three of those following:

- Profits divided by sales
- Return on assets
- Rate of return on capital employed
- Operating income divided by sales
- Gross profit divided by operating expenses

International Ratios

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Transfer pricing audits in the United States are more likely if the foreign portion of total activities is larger. The following ratios should be considered:

- Imports into the United States divided by U.S. sales
- Intercompany sales divided by U.S. sales
- U.S.-connected products or services (export and import) divided by total gross revenue

[9] Treas. Reg. § 1.6038A; *see* R. Feinschreiber, *Tax Reporting for Foreign-Owned U.S. Corporations* (New York: John Wiley & Sons, Inc., 1992), Chapter 3.

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Other Criteria

A company could use criteria other than the size of the business, profitability, or international ratios to assess the potential transfer pricing exposure. Additional criteria could include the following:

- *The industry.* Companies that are in industries that are subject to scrutiny by the IRS such as automobiles, electronics, financial services, and others
- *Notoriety.* Companies in which the media would be interested, whether because of the product or service, or because the company has a large number of shareholders or a large number of consumers, or the company has received present or prior publicity
- *Nationality of the company.* Especially companies in which the headquarters are in a country that has a large surplus with the United States
- *Location of subsidiaries.* The presence of tax haven subsidiaries makes the entire operations of the company suspect.
- *Prior tax history.* Including tax adjustments, recurrent U.S. net operating losses

Practical Approaches

Consider the following potential transfer pricing approaches:

- ***The international portion of the company's revenues are below $10 million.*** Provide the minimum information to the IRS.
- ***The international portion of the company's revenues are between $10 million and $100 million.*** Take a modest approach to protecting the company. John Wiley & Sons, Inc. prepared this book to directly address companies such as these.
- ***The international portion of the company's revenues are $100 million or more.*** Consider developing a thorough, comprehensive approach, especially when the company is much larger than $100 million in international sales. John Wiley & Sons, Inc. prepared the *Transfer Pricing Handbook* to directly address companies such as these.

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