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Transfer Pricing in the U.S.

Documenting transfer pricing policy: a comparative U.S./ multijurisdictional approach

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The Statute

- **IRC Sec. 482**: In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) ***owned or controlled directly or indirectly by the same interests***, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary ***in order to prevent evasion of taxes*** or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Control

- **Treas. Reg. 1.482-1(i)(4) Controlled** includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

- **Treas. Reg.1.482-1(i)(5) Controlled taxpayer** means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers. Uncontrolled taxpayer means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests.

Control (continue…)

- **Treas. Reg. 1.482-1(i)(6) Group, controlled group, and group of controlled taxpayers** mean the taxpayers owned or controlled directly or indirectly by the same interests.

Arm’s Length

- A controlled taxpayer has to demonstrate that the transaction fulfill the arm’s length standard.

- **Treas. Reg. 1.482-1(b)** “Arm's length standard--(1) In general. In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result).

- In conclusion an arm's-length price for a transaction is what the price of that transaction would be on the open market.

Best Method

- US transfer pricing law requires that a controlled taxpayer uses the **best method rule** to determine which transfer pricing methodology is most appropriate for determining the arm's-length price of a given transaction. Treas. Reg. Sec. 1.482-1(c). Those methods are enumerated in the Regulations and are the following:
  - Comparable Uncontrolled Price Method (CUP);
  - Resale Price Method (RPM);
  - Cost Plus;
  - Comparable Profit Method (CPM);
  - Profit split method of Transfer Pricing;

- The best method vary depending on facts, circumstances and on the kind of transaction and there is no hierarchy of method specified in the law and regulations.

Comparability

- **Treas. Reg. Sec. 1.482-1(i) Comparability**. The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors for determining comparability and after making adjustments for differences, as described in Sec. 1.482-1(d)(2) (Standard of comparability).

- To determine the degree of comparability between the controlled and uncontrolled transactions the following factors are relevant (Treas Reg.Sec. 1.482-1(i)):
  - Completeness and accuracy of data
  - Reliability of assumptions
  - Sensitivity of results to deficiencies in data and assumptions.

Transfer Pricing Methods

- **Comparable Uncontrolled Price Method (CUP)** Treas. Reg. 1.482-3(b): The comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

- A CUP may arise where:
  - the taxpayer or another member of the group **sells or buys** the particular product, in similar quantities and under similar terms to arm's length parties in similar markets (an internal comparable);
  - an arm's length party **sells or buys** the particular product, in similar quantities and under similar terms to another arm's length party in similar markets (an external comparable);

Transfer Pricing Methods (continue …)

- **Resale Price Method (RPM)** Treas. Reg. 1.482-3(b): The resale price method evaluates whether the amount charged in a controlled transaction is arm's length by **reference to the gross profit margin realized** in comparable uncontrolled transactions. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the tangible goods by physically altering the goods before resale.
- The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review
- The applicable resale price is equal to either the resale price of the particular item of property involved or the price at which contemporaneous resales of the same property are made

Transfer Pricing Methods (continue …)

- **Cost Plus** Treas. Reg. 1.482-3(d).

- The cost plus method evaluates whether the amount charged in a controlled transaction is arm's length by reference to **the gross profit markup realized** in comparable uncontrolled transactions.

- The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction.

Transfer Pricing Methods (continue …)

- **Comparable Profit Method (CPM)** Treas. Reg. Sec. 1.482-5: The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on **objective measures of profitability** (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.

- Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit).

Transfer Pricing Methods (continue …)

- **Profit split method of Transfer Pricing** Treas. Reg. 1.482-6: The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the **relative value of each controlled taxpayer's contribution to that combined operating profit or loss**.

- It is a two steps method:
  - The *first step* is to **determine the total profit** earned by the parties from a controlled transaction. The profit to be split is generally the operating profit, before the deduction of interest and taxes.
  - The *second step* is to **split the profit between the parties** based on the relative value of their contributions to the non-arm's length transactions, considering the functions performed, the assets used, and the risks assumed by each non-arm's length party, in relation to what arm's length parties would have received.

Transfer Pricing Methods (continue …)

- **Transactional Net Margin Method (TNMM)** is another method to determine if a transaction follows the arm's length standards. Such method is established by the OECD Regulations.

- The TNMM:
  - **compares the net profit margin** of a taxpayer arising from a non-arm's length transaction with the net profit margins realized by arm's length parties from similar transactions; and
  - examines the net profit margin relative to an appropriate base such as costs, sales or assets.

Penalties

- IRC Sec. 6662:
  - Substantial valuation - 20% penalty:
    - 1)f the valuation of any transfer price is 200% greater or 50% or less of an arm's-length transfer price; or
    - 2) if the net §482 adjustment for the particular taxable year exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts.
  - Gross valuation - 40% penalty:
    - 1)if the valuation of any transfer price is 400% greater or 25% or less of an arm's-length transfer price; or
    - 2) if the net §482 adjustment for the particular taxable year exceeds the lesser of $20 million or 20% of the taxpayer's gross.

Documentation Requirements

- Taxpayers need to reasonably and contemporaneously document their efforts to comply with the arm's length principle.

- Under Treas. Reg. 1.6662-6(d)(2)(iii) penalties may be avoided only if the taxpayer maintains contemporaneous documentation meeting requirements in the regulations, and provides such documentation to the IRS within 30 days of IRS request.

- The documentation must be in existence when the return is filed and is divided into two categories, 1) **principal documents** - Treas. Reg. 1.6662-6(d)(2)(iii)(B) and 2) **background documents** - Treas. Reg. 1.6662-6(d)(2)(iii)(C).

Documentation Requirements (continue …)

- ***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:
  - 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;
  - 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;
  - Any documentation explicitly required by the regulations under section 482;
  - A description of the method selected and an explanation of why that method was selected;

Documentation Requirements (continue …)

- A description of the alternative methods that were considered and an explanation of why they were not selected;
- A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions.
- A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;
- An explanation of the economic analysis and projections relied upon in developing the method.
- 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
- A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

Documentation Requirements (continue …)

- ***Background documents*** support the assumptions, conclusions, and positions contained in the principal documents.

- 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.

Advance Price Agreement (APA)

- APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method.

- APAs are not available for all transactions and they have up-front costs. The process to obtain an APA is described in IRS Revenue Procedure 2006-9, published on January 9, 2006.

PATA Guidelines

- The U.S. is a member of the Pacific Association of Tax Administrators (PATA) with Australia, Canada and Japan.

- PATA is providing principles under which taxpayers can create uniform transfer pricing documentation so that one set of documentation can meet their respective transfer pricing documentation provisions ("PATA Documentation Package").

- Use of this PATA Documentation Package by taxpayers is voluntary and does not impose any legal requirements greater than those imposed under the local laws of a PATA member.

PATA Guidelines (continue …)

- The documentation required is the following:
  - **Organizational Structure:** Identification of the participants in the related party dealings and their relationship, a description of taxpayer's worldwide organizational and its business
  - **Nature of the business/industry and market conditions:** An outline of the business,the corporate business plans, An explanation of capital relationships (e.g., balance and source of debt and equity funding)relevant to the transactions
  - **Controlled transactions** A description of the controlled transactions, copies of all relevant inter-company agreements
  - **Assumptions, strategies, policies** Relevant information regarding business strategies and special circumstances at issue, information regarding factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the related party group as a whole

PATA Guidelines (continue …)

- **Cost contribution arrangements (CCA):** A copy of the CCA agreement that is contemporaneous with its formation (and any revision) and any other agreements relating to the application of the CCA between the CCA participants, the total amount of contributions incurred pursuant to the arrangement.
- **Comparability, functional and risk analysis:** Description of the comparables including, documentation to support material factors that could affect prices or profits in arm's length dealings, adjustments (and reasons for those adjustments) made to the comparables, Supporting transfer pricing methodology or methodologies used.
- **Selection and application of the transfer pricing method:** Description of the method selected and the reasons why it was selected and of the factors considered and the analysis performed to determine the transfer pricing and an explanation of why alternate methods considered were not selected
- **Background documents:** Documents that provide the foundation for or otherwise support or were referred to in developing the transfer pricing analysis

EU Transfer Pricing documentation

- On June 27, 2006 the European Council approved the Code of Conduct on transfer pricing documentation (EUTPD) that standardizes the documentation that multinationals enterprises (MNE) must provide to tax authorities on their pricing of cross-border intra-group transactions.

- The use of EUTPD is optional for MNE but is should be applied in a way consistent throughout the EU and from year to year.

- There are 2 sets of documentation that multinationals must provide:
  - 1) **the master-file**: one set of documentation containing common standardized information relevant for all EU group members;
  - 2) **country specific documentation:** several set of documentation each containing country specific information.

EU Transfer Pricing documentation

- The **master-file** should contain the following:
  - General description of the business and of the business strategy;
  - General description of the MNE group's organizational, legal and operational structure;
  - General description of the associated enterprises engaged in controlled transactions involving enterprises in the EU;
  - General description of the controlled transactions involving associated enterprises in the EU;
  - General description of function performed, risks assumed and their changes compared to the previous tax year;
  - Ownership of intangibles or royalties paid or received;
  - The MNE's group inter-company transfer pricing policy/
  - List of contribution agreements, APA and rulings covering transfer pricing aspect as far as groups members in the EU are affected.

EU Transfer Pricing documentation

- The **country-specific documentation** supplements the masterfile and should contain the following:
  - A detailed description of the business and business's strategies;
  - Information on country-specific controlled transactions;
  - A comparability analysis;
  - An explanation of the selections and applications of the transfer pricing method(s);
  - Relevant information on internal and/or external comparables if available;
  - A description of the implementation and application of the group's inter-company transfer pricing policy.

OECD Guidelines

- On July 22, 2010 the OECD approved the 2010 version of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

- The guidelines are not law, and member countries are encouraged (but not required) to follow them.

- The guidelines recommend that taxpayers to make reasonable efforts at the time that transfer pricing is established to determine whether their transfer pricing results meet the arm's-length standard, advising taxpayers that it would be "prudent" to document those efforts on a <u>contemporaneous</u> basis.

OECD Guidelines

- The OECD Guidelines do not give a specific list of documents that a taxpayer must produce since it depends on the fact and circumstances, however they list documents that could be useful to taxpayers:
  – Information about the associated enterprises involved in a controlled transaction (an outline of the business, structure of the organization, ownership linkage with the MNE's group, etc…)
  – Information about the the transaction at issue and the functions performed;
  – Information on pricing, including business strategies and special circumstances at issue;
  – Information on selection, application and consistency with the arm's length principle of the transfer pricing method used;
  – General commercial and industry conditions affecting the taxpayer;
  – Financial information;
  – Information on risks assumed.

U.S. Customs and Border Protection (CBP)

- Merchandise imported into the United States is appraised for **customs purposes** in accordance with Sec. 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979.

- CBP applies different methods from the IRS to determine whether the transfer price is arm's length.

- The primary method of appraisement is ***transaction value*** ("the price actually paid or payable for the merchandise when sold for exportation to the United States," plus amounts for certain statutorily enumerated additions to the extent not otherwise included in the price actually paid or payable). When there is no transaction value, other valuation methods are to be applied in sequence.

U.S. Customs and Border Protection (CBP)

- Transaction value between a related buyer and seller is acceptable if the importation meets either of two tests – (19 U.S.C. §1401a(b)(2)(B)):
  - 1) **circumstances of sale:** the transaction value between a related buyer and seller is acceptable if an examination of the circumstances of the sale of the imported merchandise indicates that the relationship between the buyer and the seller did not influence the price actually paid or payable. 19 U.S.C. §1401a(b)(2)(B); or
  - 2**) test values:** the transaction value between a related buyer and seller is acceptable if the transaction value of the imported merchandise closely approximates one of the following "test values": (i) the transaction value of identical merchandise, or of similar merchandise, in sales to unrelated buyers in the United States; (ii) the deductive value or computed value for identical merchandise of similar merchandise; (iii) but only if each value referred to in clause (i) or (ii) that is used for comparison relates to merchandise that was exported to the United States at or about the same time as the imported merchandise

U.S. Customs and Border Protection (CBP)

- Based on the fact that the methods for determining the acceptability of transaction value is different for tax law and for CBP purposes, the CBP has ruled that the fact that the importer's transfer pricing methodology satisfies one of the IRS methods is not determinative of whether it is an acceptable transaction value for customs purposes.

- The mere fact that an importer provides CBP with an APA or transfer pricing study is not sufficient to establish that a related party transaction value is acceptable. A related party transaction value will be considered acceptable only if it satisfies either the circumstances of sale test or closely approximates one of the test values as provided in customs value law. The importer must provide information and evidence regarding the circumstances of sale and/or test values.

Final Considerations

Global Approach

- In a perfect worlds, a MNE would like to be able to:
  - Rely on a standardized set of transfer pricing rules and documentation prepared centrally that is valid for all jurisdictions in which it operates and equally suitable for income tax, VAT and customs purposes;
  - Take a global or regional approach (namely, use global or regional comparables) when assessing and documenting transfer prices.
- Challenges of global approach: difficulties in dealing with economic differences of various markets which reflect on margins, operating expenses, availability of comparables, selection of best transfer pricing method; handling legal differences of relevant concepts in various jurisdictions (e.g., legal or economic ownership of intangibles).

Local Constraints and Regional Harmonization

- Each country (including EU member states) has a different set or rules for establishing and documenting transfer pricing.
- Regional trend towards harmonization/coordination (EUTPD and PATA documentation package, OECD guidelines).
- Regional packages do not have legally binding force.
- However, countries tend to adapt or enact their domestic rules in way to make them consistent with relevant regional frameworks.

Strategy

- Establish TP policy and prepare/collect information globally; produce documentation regionally and check/adapt/review it locally.

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- Mark began his international legal career following his graduation from Georgetown University Law Center with a post graduate law degree in International and Comparative Law.
- Over a twenty year career in the international business field, and travelling the world many times over, Mark has acquired an extensive network of international associates and colleagues at the highest levels of law, business, academia, and world affairs.
- Early in his career, Mark joined the Finmeccanica Group of Rome, Italy for which he served as in-house counsel in the U.S. for a period of about ten years, working at several cross border reorganizations and M&A transactions that reshaped the company' structure and business operations in the U.S.