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The Transfer Pricing Challenge

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Transfer pricing is a challenge to both taxpayer and government. This book focuses on the U.S. laws regulating the pricing of transfers of property and services, including transfers of intangible property, among affiliated entities that operate as part of a multi-national enterprise (MNE).

The Transfer Pricing Challenge

Q 1.1 What is the transfer pricing "challenge"?

The term "transfer pricing" refers to the prices at which related entities within an MNE transfer goods, services, and intangible property among one another. Where the entities transferring property or services are part of a larger enterprise, their pricing of intercompany transactions may have limited economic impact on the enterprise as a whole. In general, the pre-tax profits of an MNE will be affected only by the pricing of the MNE's transactions with third parties, like employees, management, suppliers, licensors, lenders, and customers and not by the prices that the affiliates making up the MNE charge one another. However, transfer pricing can affect the after-tax profits of an MNE in one important way: transfer pricing affects the income tax liabilities of the affiliates within the MNE and, therefore, the after-tax profitability of the overall enterprise.

Where affiliated entities engage in so-called "controlled transactions" across different taxing jurisdictions, the pricing of the transactions will impact the profits reported to the local taxing authorities.

EXAMPLE: Assume there are two related companies, A and B. A owns a trademark that it wishes to license to its affiliate, B, for use in B's business. A is taxable only in Country A, and B is taxable only in Country B. The more A charges B for the use of A's trademark, the greater A's profits and the income tax payable to Country A, and the less B's profits and the income tax payable to Country B. If Country A has an income tax rate of 10%, and Country B has an income tax rate of 40%, the incremental savings to the overall MNE from increases in the royalty can be significant.

For many years, the IRS and foreign taxing authorities have attacked perceived transfer pricing abuses. This is particularly the case where there are significant differences in the effective tax rates applicable to income that is shifted by transfer pricing practices. Even where there is not a differential in tax rates among jurisdictions, a country may perceive that an MNE's transfer pricing practices leave the country with too little income and therefore too little tax revenue. Most countries, including the United States, have established the "arm's-length" principle as their standard for evaluating whether taxpayers' transfer prices are appropriate. This international standard reflects a policy decision that taxpayers engaged in controlled transactions should allocate the profits from those transactions in a manner that approximates the allocation of profits that would occur between unrelated parties that conducted similar transactions in the open market.[1] As discussed in chapter 17, this arm's-length standard is a keystone of the international regulatory regime governing transfer pricing.

Q 1.2 Why are taxing authorities like the IRS so focused on transfer pricing?

MNEs present unique challenges to taxing authorities in the United States and around the world. These firms engage in activities in multiple jurisdictions to generate value and profits. In many cases, MNEs are organized and managed regionally or globally along

functional lines that do not conform to political borders. Management may assemble teams from various affiliates around the world and ask them to work together to accomplish the MNE's business objectives. Given the way that MNEs operate, it can be difficult to measure the relative contributions of activities in various jurisdictions to an MNE's overall profits.[2] In effect, the arm's-length standard requires taxpayers, advisors, and taxing authorities to engage in a counter-factual thought experiment by asking: if the various elements of an integrated MNE operated as separate firms and bargained with each other, what prices would they establish among themselves? This exercise may be quite difficult because one of the economic rationales for assembling a large integrated MNE is that the profit generated by the MNE as a whole is greater than the sum of the profits that each part of the MNE would generate on its own.

This lack of a precise measure of the profit created in each jurisdiction may matter little to the management and operation of the MNE's business. However, for government taxing authorities like the IRS, and the tax professionals responsible for reporting the MNE's income in each jurisdiction, the inability to precisely measure the profit created in their jurisdiction is a major problem. Each government wants to tax the profits generated by their taxpayers and activities in their country, and they often see the arrangements for transferring value among the entities of MNEs as a major threat to their tax base.

An additional layer of complication in the measurement problem facing governments and tax professionals is the critical role that intangible property often plays in generating income for MNEs.[3] Intangible property is like the "special sauce" that allows an MNE to generate premium returns. Intangibles can consist not just of patents or trademarks, but also methods, systems, know-how, licenses, contracts, proprietary data, customer lists, and certain business relationships. Significantly, not all transfers or allocations of value within an MNE are subject to transfer pricing regulation.[4] As a practical matter, it can be difficult to identify the intangible property that contributes to an MNE's income, which entities hold rights to exploit the intangible property, and the relative contribution of intangible property to a specific entity's profitability. Should the profits generated by intangible property or similar attributes (that is, profits above normal returns)

be allocated to the jurisdiction in which the intangible property was developed, the jurisdiction in which the intangible property is used, the jurisdiction in which the risks of intangible development were borne, or all of the above?

Q 1.3 What can the IRS do to address perceived transfer pricing abuses?

Congress and the IRS have long sought to prevent taxpayers from using transfer pricing strategies to inappropriately erode the U.S. tax base. Today, section 482 of the Internal Revenue Code (the "Code") empowers the IRS to distribute, apportion or allocate income, deductions and allowances among taxpayers that are owned or controlled by the same interests, if the IRS determines that such distribution, apportionment or allocation is necessary to prevent evasion of taxes or clearly to reflect the income of one or more of the taxpayers. This extraordinary grant of power to the IRS is backed up by hundreds of pages of regulations governing how MNEs must report the results of different types of transactions among their controlled affiliates on their U.S. tax returns, the penalties for failing properly to report the results of these "controlled transactions," and the records that taxpayers must have in place and provide to IRS auditors if they wish to avoid such penalties. These regulations, which never made for exciting reading, have grown more complex and tedious with time as the IRS and Treasury have issued revisions and enhancements to address new transactions or problems.

Q 1.4 Does the 2017 tax reform legislation eliminate the transfer pricing challenge?

The Tax Cuts and Jobs Act (2017)[5] changed, but did not eliminate, the incentives to shift income from the United States abroad, including through transfer pricing strategies.[6] Moreover, the fundamental problems of getting the transfer pricing right, limiting tax controversies, and avoiding double taxation remain.[7]

In the 2017 legislation, Congress enacted major changes to the U.S. international tax rules in an attempt to alter taxpayer incentives to engage in transfer pricing strategies, and to bolster the IRS's powers

to address transfer pricing issues. Congress reduced the top U.S. corporate income tax rate to 21%, which is more in line with the top rates of the United States' major trading partners. This change reduced the incentive to shift income out of the United States. However, Congress also moved the U.S. tax system closer to a territorial system by granting U.S. corporations an exclusion from income for dividends from certain foreign subsidiaries. The ability to exclude foreign dividends increases incentives to engage in aggressive transfer pricing strategies to shift income from the United States to foreign subsidiaries, which can then dividend back their earnings tax free.

To reduce the incentive to shift income out of the United States, Congress added to the 2017 legislation certain anti-base erosion "guard rails," including: (i) the Base Erosion and Anti-Abuse (BEAT) tax, which is a minimum tax applicable to MNEs with more than $500 million of gross receipts that make deductible payments to foreign affiliates;[8] and (ii) the Global Intangible Low-Taxed Income (GILTI) tax.[9] Both provisions are designed to discourage MNEs from shifting income out of the United States through payments to foreign affiliates, including through transfer pricing.

As a carrot to keeping intangible property in the United States, the 2017 legislation created a deduction for foreign-derived intangible income.[10] This deduction can substantially reduce the effective rate on income earned from intangible property held in the United States.

Q 1.5 Why should MNEs focus on transfer pricing?

MNEs should focus on transfer pricing because it provides them tools to optimize their tax position and because ignoring transfer pricing is a recipe for disputes with the IRS and other taxing authorities. Tax rates around the world vary, and some countries maintain favorable tax environments to attract investment by MNEs in their jurisdictions. Together with advances in communications and logistics, the existence of countries with favorable tax environments has made it possible for MNEs to centrally locate in favorable tax environments entities that act as regional or global entrepreneurs. These entrepreneurial entities can undertake the risks of the success or failure of an enterprise on a regional or global basis, and thereafter receive the premium returns from such risks. If successful, allocation of income

to low-tax environments results in less cash tax paid by the MNE and could result in a significantly lower effective tax rate, and therefore greater after-tax earnings. An MNE can achieve these earnings benefits even where the parent company is resident in a country, such as the United States, that taxes the income of its corporate residents on a worldwide basis, if the MNE takes the position that the earnings subject to low rates of foreign tax are permanently reinvested offshore. For MNEs that have organized global or regional entrepreneurial entities in relatively low-tax environments or otherwise proactively utilized transfer pricing planning, it is critical that such planning can be defended. A misstep in developing the transfer pricing strategy can result in cash tax liabilities and earnings restatements in the hundreds of millions or even billions of dollars.

Q 1.6 Can taxpayers avoid disputes by simply "playing it straight" with their transfer pricing?

Not always. Transfer pricing is an area where taxpayers can get swept into a dispute with the IRS or a foreign taxing authority notwithstanding good-faith efforts to comply with the spirit and letter of the law. Indeed, a taxpayer may be caught up in a transfer pricing dispute notwithstanding that it is relatively indifferent about whether its income is taxed in the United States or abroad. For example, where an MNE has controlled transactions between two countries with similar tax rates, the MNE may not care which country taxes the income from those transactions. The cash tax cost is the same if the MNE allocates the income between the two taxing jurisdictions on a 50/50 basis or a 90/10 basis. Moreover, depending on the MNE's home country taxing rules, and financial accounting practices, the MNE may be relatively indifferent as to income allocation even between two countries with differing tax rates. For example, if the MNE's parent company is resident in a country that taxes income on a worldwide basis (such as the United States) and accounts on a current basis for the eventual U.S. tax to be paid on earnings of a foreign subsidiary, the MNE will be indifferent from a financial accounting perspective as between the allocation of income between the U.S. parent company and the foreign subsidiary.

Whether or not a taxpayer is indifferent, however, the two countries may care very much because one country's gain is the other's loss.[11] Moving from a 50/50 split to 90/10 leaves one country collecting more tax and the other country collecting far less. Given this dynamic, MNEs may find themselves at the center of long drawn-out disputes about which they care little. There is no way for the MNE to take a "conservative position" in this context because the position that allocates relatively more income to one jurisdiction may be perceived as "aggressive" by the other jurisdiction.

Elements of a Transfer Pricing Strategy

Q 1.7 What are the basic elements of a transfer pricing compliance strategy?

Developing a robust, defensible transfer pricing strategy is a complex undertaking involving numerous tasks that require multiple skill sets. These tasks fall into the following basic phases:

(i) education, investigation, and issue spotting,

(ii) development or evaluation of explicit transfer pricing policies,

(iii) evaluation of potential transfer pricing methodologies,

(iv) searching for and evaluating comparable transactions,

(v) adoption of a transfer pricing methodology and reporting the results on the tax return,

(vi) documentation of the process and analysis used in selecting transfer pricing methodology, and

(vii) preparing to defend the return position in the event of an audit or challenge.

Separately, taxpayers should consider alternatives to the traditional approach of adopting a transfer pricing position on the tax return and waiting for an IRS audit. For example, taxpayers may agree in advance with the IRS and/or the foreign taxing authority on the appropriate transfer pricing methodology through an Advance Pricing Agreement (APA). We discuss APAs in detail in chapter 16.

Education, Investigation, and Issue Spotting

Q 1.7.1 What is involved in the first phase: education, investigation, and issue spotting?

If you are reading this book, you have already embarked on the first phase. It begins with learning about the types of transactions within your MNE with the potential to raise transfer pricing issues, the applicable statutory and regulatory regime, and the requirements that these statutes and regulations put on taxpayers to evaluate the transfer prices for their controlled transactions and report on their tax returns results that conform to the regulatory standards.

It also necessarily includes a thorough investigation of the company's facts. What are the company's significant cross-border transactions with affiliates? Do they involve transfers of goods, services, intangible property, or some combination? How are these intercompany transactions structured, and should there be changes to these structures to optimize the MNE's transfer pricing position? What are the functions and risks undertaken by each affiliate, and should you consider changing those functions and risks to optimize the MNE's transfer pricing position? For example, is one affiliate responsible for developing the technology and design of the product, while another is responsible for marketing the product in a new territory? What are the explicit or implicit contractual allocations of risks between the two affiliates, and are such allocations consistent with their course of conduct?

Ultimately, the well-advised taxpayer will need to develop a "functional analysis" that describes the transactions and functions and risks of the parties, and places these facts in the context of the MNE's business. This functional analysis is an important tool for identifying comparable arm's-length transactions, selecting a transfer pricing methodology, and determining the proper arm's-length range for the MNE's controlled transactions. IRS regulations require the taxpayer to include the functional analysis as part of the documentation that the taxpayer must have available to back up its tax return to avoid penalties in the case of an adjustment.

Development or Evaluation of Explicit Transfer Pricing Policies

Q 1.7.2 What is involved in the second phase: development or evaluation of explicit transfer pricing policies?

In the second phase, the taxpayers should evaluate the options available to them for structuring their related party transactions. For example, if there is manufacturing within the group, each entity doing the physical manufacturing can be structured as an entrepreneur, or as a contract manufacturer or toller taking direction from an entrepreneurial principal in a different jurisdiction. If there is local-country distribution within the group, the distributors could be structured as entrepreneurs, as limited risk distributors, or as sales agents. If process intangibles are developed within the group, the risks of intangible development could be borne by the entity doing the research and development (R&D), by a single principal that will use the intellectual property (IP) in its business but also license to other affiliates, or by some or all affiliated users through a cost sharing arrangement. These choices related to structuring related party transactions are important for transfer pricing purposes for two reasons. First, premium returns generally go with risk. Second, the simpler the operations of an entity, the easier it will be to benchmark the entity's results against those of comparable companies for which data is available. Choosing limited risk distributors, for example, virtually assures that, in the absence of a comparable uncontrolled price (CUP), the best method would be a method that focused on the profits of the limited risk distributor under a comparable profits method (CPM) or gross margin analysis.[12]

Once the taxpayer has chosen a structure for its related party transactions, it is critically important that the taxpayer contemporaneously memorialize that structure in a written contract. The IRS and other taxing authorities will generally respect the terms of a contemporaneous written contracts, including allocations of risk, so long as the contract terms are consistent with the taxpayer's actual

course of conduct. Absent written contracts, the taxing authority will have discretion to impute contractual terms consistent with its view of the course of conduct between the parties.[13]

Evaluation of Potential Transfer Pricing Methodologies

Q 1.7.3 What is involved in the third phase: evaluation of potential transfer pricing methodologies?

Under the IRS's transfer pricing regulations, taxpayers must report results from their controlled transactions that are consistent with the results that would have been realized by transacting at arm's length. The regulations require the taxpayer to select a transfer pricing method for measuring whether the results reported on the taxpayer's return are consistent with the arm's-length standard. As explained in chapter 5, there is no definitive hierarchy of potential methods. Very generally, some methods compare the transfer prices charged in the controlled transaction to the prices in specific transactions that were conducted at arm's length, such as transactions between the MNE and a third party or a transaction between two third parties that were not related. These are called transaction-based methods. Other methods compare the profits reported by the parties to the controlled transaction with the profits reported by independent, stand-alone companies that undertake similar functions and risks. These are called profits-based methods. Ultimately, the regulations require the taxpayer to select the transfer pricing method that, under the facts and circumstances, gives the most reliable measure of an arm's-length result (the "Best Method Rule"). In practice, the factual investigation, including the availability of data and information about the type of transaction and the parties' functions and risks, will help to eliminate many of the potential methods, typically leaving only a few methods that merit further analysis. We discuss the Best Method Rule, types of transfer pricing methods, and their potential applicability to various categories of transactions in chapters 5 and 11 through 14.

Using Comparable Transactions to Establish an Arm's-Length Price

Q 1.7.4 What is involved in the fourth phase: searching for and evaluating comparable transactions that can help establish an arm's-length price?

Although the taxpayer may be able to reduce the number of potentially applicable transfer pricing methods down to a reasonable list, it cannot select the best method until it knows whether it can obtain sufficient data on the kinds of comparable arm's-length transactions ("comparables") that are required to apply each method. As a practical matter, it is often difficult to obtain data on comparable transactions unless the taxpayer, itself, has engaged in comparable transactions with third parties ("internal comparables"). For many of the most contentious types of transactions, such as transfers of intangible property, the property may not be transferred to third parties under the same circumstances. Accordingly, these taxpayers may not be able to apply a transaction-based method, and will instead have to apply a profits-based method. If the taxpayer has taken into account the availability of comparables for a profits-based method when structuring its controlled transactions, it is likely to have a leg up in this phase.[14]

The regulations state that, in selecting the best method, the primary factors to take into account are (i) the degree of comparability between the controlled transaction and any uncontrolled comparable transactions, and (ii) the availability of complete and accurate data and reliability of assumptions used in applying a method. Some methods are more sensitive to deficiencies in the data or assumptions than other methods. Accordingly, it is necessary to have a thorough understanding of the data available on potentially comparable transactions, and the reliability of any assumptions used in making adjustments to account for differences between the controlled and comparable transactions, before selecting a transfer pricing method as the "best method." Obtaining robust data on transactions between unrelated parties is one of the greatest practical hurdles to clear in conducting a transfer pricing analysis. As discussed above, taxpayers

can reduce the burden associated with obtaining comparables by structuring their controlled transactions so that one or the other of the controlled taxpayers in the transaction fits the profile of the types of comparables that are readily available.

Inherent in the regulatory concept of a "comparable" arm's-length transaction is the notion that an arm's-length transaction need not be identical in every detail to the taxpayer's controlled transaction. The taxpayer can make adjustments to account for differences between the arm's-length transaction and the controlled transaction, if those adjustments are based on reliable assumptions. For example, where the taxpayer's contract in a controlled transaction requires payment upon delivery, and the uncontrolled transaction requires payment within ninety days, it is reasonable to make an adjustment to the arm's-length price to account for the difference in payment terms based on the time value of money. Similarly, in the context of profits-based methods, adjustments may be made to account for different levels of inventory held by the tested party and by the comparable companies. The ability to make adjustments is critical, because it gives taxpayers some leeway in assembling sets of comparable transactions. Accordingly, in gathering information on comparable transactions, the taxpayer should consider whether adjustments will include an uncontrolled transaction within the group of comparables.

Taxpayers must conduct a thorough search for comparable transactions before selecting a transfer pricing method under the Best Method Rule. The taxpayer should search within the company for any transactions with third parties that could be used as comparable transactions. The advantage of these internal comparables is that the taxpayer typically has a rather robust store of information about the facts and circumstances associated with its own transactions. The taxpayer should also search for information on comparable transactions between unrelated parties. For example, third parties may be required to publicly disclose information about their transactions to regulators or the SEC. Finally, taxpayers should review public databases for information on the profits and losses of unrelated companies that perform similar functions and bear similar risks to the affiliates in the controlled transactions. As discussed in chapter 5, this information on third-party taxpayers is useful in applying profits-based transfer pricing methods under the regulations.

Adopting and Reporting a Transfer Pricing Methodology

Q 1.7.5 What is involved in the fifth phase: adoption of a transfer pricing methodology and reporting the results on the tax return?

Having gathered the available data on comparable transactions or companies, the taxpayer must analyze the potentially applicable transfer pricing methods. In light of the available information on comparable uncontrolled transactions or taxpayers (CUT), the taxpayer must select the best method for measuring an arm's-length result. The taxpayer should review each of the potential methods that would appear to have some applicability. For example, in a situation where the taxpayer has identified internal comparable transactions, gathered sufficient and accurate data on those transactions, and can make reliable adjustments as necessary to account for differences in the controlled transactions, the taxpayer may conclude that a transaction-based method is the best method for measuring the arm's-length result in the controlled transaction. Where the taxpayer lacks data on specific uncontrolled transactions, but has identified profitability data with respect to independent companies with similar functions and risks to the taxpayer's affiliate, then one of the profits-based methods may be the best method. As noted above, if the taxpayer has taken into account the types of comparables available when structuring its transactions, it likely will have a leg up in applying the profits-based method. In some cases, the taxpayer may decide that the best approach is to use a second method to confirm the results of the best method.

Once the taxpayer has selected a transfer pricing method under the Best Method Rule, it must apply that method, using the uncontrolled comparable transactions that it has identified as applicable under the selected method, to establish an arm's-length result for its controlled transactions. In some cases, application of a transfer method will establish a single arm's-length price, but in other cases the method will establish a range of prices. Chapter 4 discusses establishing an arm's-length range. The taxpayer then must analyze whether the results of the taxpayer's controlled transactions are consistent with

the arm's-length price, or range. If not, the taxpayer must report an adjustment to the results of the controlled transactions on its income tax return.

Documentation Requirements

Q 1.7.6 What is involved in the sixth phase: documentation of process and analysis used in selecting transfer pricing methodology?

IRS regulations require taxpayers to document their selection and application of transfer pricing methods to avoid penalties in the case of an adjustment. In addition, the taxpayer must have that documentation available for delivery to the IRS at the outset of an audit. As explained in chapter 9, if the taxpayer fails to maintain and deliver this documentation, it can be subject to significant monetary penalties in the case of an adjustment.

To avoid the spectre of these penalties, taxpayers should take the time to thoroughly document their compliance with the transfer pricing regulations. Typically, taxpayers choose to have an outside consultant conduct the transfer pricing analysis and prepare a report, which becomes the centerpiece of the taxpayer's documentation. However, many taxpayers conduct their own studies and prepare their own documentation. Regardless of the author, the taxpayer's documentation should include a discussion of the taxpayer's facts, functional analysis, the selection of comparables, any adjustments to the comparables, the analysis of potential methods under the Best Method Rule, the reasons why potential methods were rejected, and why the final method was selected as the best method. If the taxpayer applies a second method to confirm the best method, this decision also should be explained. As detailed in chapter 9, in addition to preparing the transfer pricing study, taxpayers must maintain on hand certain types of backup documentation.

Preparing a Defense of Your Transfer Pricing

Q 1.7.7 What is involved in the seventh phase: preparing to defend the return position in the event of an IRS audit or challenge?

In many cases, the taxpayer's documentation of its transfer pricing study will provide a solid basis for defending the transfer pricing in the event of an audit. However, the taxpayer should prepare a more fulsome transfer pricing defense for those controlled transactions that are likely to attract the attention of the IRS, have particularly high stakes, and/or go to the heart of the taxpayer's long-term business strategy. In this regard, it is important to keep in mind that the taxpayer typically bears the burden of proof in overcoming an IRS transfer pricing adjustment. Accordingly, the natural deterioration of the factual record and available evidence that tends to occur over time works to the disadvantage of taxpayers. To counteract this problem, the taxpayer can assemble a defense file that includes additional analysis of the facts and regulations, identifies potential IRS attacks, and gathers together the documents and witness statements and supplemental reports necessary to rebut those attacks.

Compliance As a Practical Matter

Q 1.8 Do companies typically create a full-blown transfer pricing study for every controlled transaction?

No. It is expensive and time-consuming to conduct a full-blown transfer pricing analysis and prepare robust documentation and defense files. Many of the controlled transactions within an MNE do not justify this expenditure of money and time because the amounts involved are small and/or the pricing of the transactions is noncontroversial. However, controlled transactions involving high value-added activities, valuable intangible property, long-term strategic structuring of the MNE's business, or significant cash flows, merit serious analysis, documentation, and preparation for audit defense. The taxpayer and its advisors must apply some judgment and prioritize

their transfer pricing issues so that each controlled transaction receives the appropriate amount of effort.

Q 1.9 What resources are available to a company for preparing its transfer pricing compliance strategy?

Many companies do not have internal resources available for transfer pricing analyses, documentation, and audit defense. Others may have enough cross-border transactions involving high value-added activities and related intangible property that they have employees dedicated to transfer pricing planning, compliance, and audit defense. In either case, there will be times when a company needs to turn to outside experts for help. Typical outside experts on transfer pricing matters include tax lawyers, accountants, and economists. The team as a whole should have the capacity to analyze the profit drivers of the taxpayer's business, suggest changes to the arrangements between affiliated entities so as to optimize the taxpayer's transfer pricing position, analyze the resulting controlled transactions, prepare a functional analysis of the transactions, including the controlled parties' functions and risks, develop functional income statements, identify comparables, apply applicable law and regulations, and evaluate the taxpayer's factual and legal case. In the context of a dispute, the team also should have a sense of how the transfer pricing issues can be best presented to the IRS and, if necessary, a court and how to protect privileged communications regarding the case. Because of the multi-faceted nature of a transfer pricing compliance effort, it is important that the team have a strong leader.

There are a number of excellent transfer pricing practices in the United States and around the world that are capable of conducting a transfer pricing analysis for purposes of preparing tax returns and documentation. In addition, a number of law firms have practices specializing in administrative resolutions of transfer pricing controversies and litigating transfer pricing cases. There also are practices that consist of economists that specialize in transfer pricing, including appearing as expert witnesses in litigation.

Q 1.10 Does compliance with U.S. transfer pricing rules protect the taxpayer from a foreign taxing authority's transfer pricing adjustment?

No. Many of the United States' trading partners have treaties with the United States that adopt the arm's-length standard for evaluating transfer pricing issues, so in theory they should be able to agree with the United States on a correct transfer price. The Organisation for Economic Co-operation and Development (OECD) member countries, including the United States, have agreed to resolve transfer pricing disputes under tax treaties based on the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "OECD Guidelines"). However, foreign taxing authorities and the IRS will have their own views of the facts and will apply the OECD Guidelines in light of their own specific transfer pricing rules. Accordingly, taxing authorities may disagree about how profits from the controlled transaction should be allocated among countries. Such disagreement is unlikely to work in the taxpayer's favor. Instead, there is a very real threat that both countries will assert the right to tax the same income. Such "double taxation" of the same income is problematic from both theoretical and practical points of view. As discussed in chapter 19, on Competent Authority, U.S. tax treaties typically include provisions for negotiations between governments to resolve double taxation issues, including transfer pricing disputes.

Q 1.11 What procedures are available for resolving transfer pricing disputes?

Resolving a transfer pricing dispute is often a truly multinational endeavor. Because MNEs are operating in more than one taxing jurisdiction, typically it is not enough to focus on the U.S. tax implications of a transfer pricing dispute. In many cases, the IRS's tax gain will be another taxing authority's tax loss—but only if the other taxing authority agrees with the IRS. Moreover, if an MNE fails to challenge certain transfer pricing adjustments to its foreign country taxes, or to obtain correlative relief from foreign taxing authorities with respect to U.S. adjustments, it may lose the ability

to claim foreign tax credits on its U.S. returns. Accordingly, managing the tax risks associated with transfer pricing requires MNEs to keep their eyes on multiple countries. As noted above, the United States has entered into a network of tax treaties with its trading partners that provide mechanisms for resolving disputes among different countries over which country has taxing jurisdiction over which portion of an MNE's income. The United States and many of its treaty partners also have programs that allow MNEs to resolve potential transfer pricing disputes in advance through an APA between the taxpayer, the IRS and the foreign taxing authority.

For those taxpayers that are unable to resolve their transfer pricing disputes, litigation may be the only option. Transfer pricing litigation is typically characterized by high tax stakes; it is not uncommon for the IRS to propose transfer pricing adjustments in the hundreds of millions or even billions of dollars. Moreover, the IRS's focus on intangibles transfers may go to the heart of a company's business model, so that the implications of an IRS position over the long run are just too costly to accept. A transfer pricing issue can become a "bet the company" case. The good news is that the IRS often has trouble prevailing in court on its most draconian transfer pricing positions. For many years, the IRS has chosen cases to litigate based on broad economic or legal theories rather than rigorous, case-specific factual development. For example, in a series of cases in the 1980s and 1990s, the IRS argued that foreign subsidiaries that held licenses to exploit technology from their U.S. parents should be treated as contract manufacturers where the licensees sold their products back to their U.S. parents. Thus, the IRS asserted, these foreign licensees should earn only the modest profits associated with a low-risk contract manufacturer.[15] More recently, the IRS has argued that cost sharing arrangements through which U.S. and foreign affiliates share the costs and risks of developing new products should nevertheless result in allocation of all premium profits to the United States where the U.S. company contributed pre-existing intangible property at the inception of the cost sharing arrangement.[16] In the past, courts often rejected the IRS's attempts to rewrite the transfer pricing law through litigation, but nevertheless found a way to give the IRS a significant piece of the case.[17] However, the IRS's recent experiences in litigating transfer pricing issues have been more decidedly negative. Courts have been

dismissive of IRS positions that are based on broad economic theories and would significantly re-write the transfer pricing laws. Instead, courts have focused on the specific facts of the taxpayer's case and rewarded taxpayers that spent time and effort developing the facts necessary to sustain their case under established precedent.

In 2010, the IRS began an effort to raise the level of its game in transfer pricing controversies. The IRS announced the creation of a Transfer Pricing Practice within the IRS to better coordinate the agency's resources on identifying, investigating, and litigating transfer pricing cases. The IRS has hired experienced attorneys from the private sector to lead this practice. Moreover, they have hired additional IRS International Examiners (IEs) to work in this area and additional economists to support these new IEs. Congress has appropriated additional funds for IRS enforcement, and there is no doubt that transfer pricing enforcement is one of the areas in which Congress expects the IRS to enhance its enforcement efforts.

Q 1.12 How will this book help me develop a transfer pricing strategy for my company?

In light of the high stakes involved and the IRS's redoubling its enforcement effort, it is critical for companies with significant cross-border controlled transactions to have a transfer pricing strategy in place. That strategy should be forward-looking, so that it lines up with the company's long-term business goals, and well documented, so that it can withstand scrutiny in the event of an IRS or foreign government audit. This book is intended to help MNEs understand the U.S. laws governing transfer pricing and the actions that MNEs must take to comply with the U.S. laws. Our intention is to introduce the subject matter so that the reader is in a position to spot potential transfer pricing issues. In addition, we discuss the necessary elements for a transfer pricing compliance strategy, including reporting obligations, documentation of transfer pricing methods, and document retention. We also discuss strategies for defending a transfer pricing audit by the IRS, resolving a transfer pricing dispute with the IRS short of litigation, and some important considerations when undertaking a transfer pricing litigation.

However, this is not intended to serve as, and indeed cannot serve as, a cookbook for transfer pricing compliance. It is simply not possible to write out a fool-proof recipe for transfer pricing strategies (for example, take 100 hours of economist time, add fifty hours of lawyer time, and twenty-five hours of accountant time to get one transfer pricing position that will withstand IRS audit). As discussed in detail in the following chapters, analysis of transfer pricing issues is fact-intensive and technically complex. It is necessary that MNEs make an up-front investment in understanding the facts surrounding their controlled transactions, analyzing the legal issues presented by those transactions, and documenting the factual and legal case for the income from controlled transactions reported on their U.S. income tax returns. Each MNE will have to develop its own recipe for compliance according to its own facts and needs. Each year, it must consider whether changes are necessary. Hopefully, this "Transfer Pricing Answer Book" will provide you with an understanding of the ingredients necessary for any successful transfer pricing strategy, how these ingredients interact with one another, and how different mixes perform in the heat of an IRS audit or litigation.

Notes to Chapter 1

1. *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ¶ 1.14 (July 2010) [hereinafter OECD Guidelines].

2. *See* E. Toder, "International Competitiveness: Who Competes against Whom and for What?," at 7 (Urban-Brookings Tax Policy Center, Jan. 10, 2012).

3. *See* OECD Guidelines, *supra* note 1; chapters 6 and 13 discuss the role of intangible property in transfer pricing regulation, but the reader will see that the issue permeates the rest of this book.

4. For example, courts hold that transfers of business opportunities are not subject to the U.S. transfer pricing regime. *See, e.g.*, Hosp. Corp. of Am. v. Comm'r, 81 T.C. 520, 590 (1983), Nonacquiescence by Commissioner at: Hospital Corp. of America, 1987-2 C.B. 1 (IRS 1987) (incorporation of foreign subsidiary to take advantage of offshore business opportunity did not constitute a transfer of intangible property to the subsidiary).

5. Tax Cuts and Jobs Act (2017), Pub. L. No. 115-97.

6. *See* Martin Sullivan, *Where Will The Factories Go? A Preliminary Assessment*, 2018 TAX NOTES at 570 (Jan. 27, 2018).

7. *See* Isabel Gottlieb, *Will Tax Reform Bring Back Patents?*, Daily Tax Rep. (BNA) (Jan. 19, 2018) (even with changes to the U.S. tax laws, other jurisdictions, like Ireland, retain some advantages as a situs for intangible property).

8. *See* I.R.C. § 59A (2018). The Tax Cuts and Jobs Act (2017), Pub. L. No. 115-97 § 14401(a), added the BEAT tax. The BEAT tax is a minimum tax and is only due if BEAT tax is greater than the regular corporate tax for a year. The BEAT tax is computed as 10% (5% transitionally for years beginning in 2018 and 12.5% for years beginning in 2026 or later) of modified taxable income. Modified taxable income is essentially regular taxable income calculated without allowance of deductions for amounts paid or accrued to related foreign persons or depreciation or amortization deductions with respect to property acquired from related foreign persons.

9. *See* I.R.C. § 951A. The Tax Cuts and Jobs Act (2017), Pub. L. No. 115-97 § 14201(a), added the GILTI provisions to subpart F. Section 951A requires U.S. shareholders of a controlled foreign corporation (CFC) to include GILTI currently in U.S. income. Generally, GILTI income is all the income earned by the CFC outside the United States not already included in the U.S. shareholders' income under subpart F, to the extent such income exceeds a 10% return to the CFC's tangible assets. New sections 960(d) and 250 reduce and may eliminate the tax cost for GILTI for corporate (not individual) U.S. shareholders. Section 250 allows a domestic corporation to deduct 50% of its GILTI income (37.5% for tax years starting in 2026), effectively resulting in a 10.5% GILTI tax rate (13.125% starting in 2026). Section 960(d) permits a domestic corporation to take deemed-paid foreign tax credits for up to

80% of foreign taxes paid on the GILTI income. As a result, a domestic corporation effectively may not pay tax with respect to GILTI income if the CFC pays foreign taxes equal to at least 13.125% (16.4% starting in 2026). Individuals who own CFCs receive no GILTI deductions and no foreign tax credit, and pay tax on the GILTI income under subpart F at their individual tax rate, which can be up to 37%.

10. I.R.C. § 250. The Tax Cuts and Jobs Act (2017), Pub. L. No. 115-97 § 14202(a), added a deduction for 37.5% (21.875% beginning in 2026) of foreign-derived intangible income (FDII). FDII is a portion of a corporation's intangible income derived from serving foreign markets. As a result of the deduction under section 250, the effective rate on FDII is 13.125%, which is substantially below the top corporate rate of 21%. *See* H.R. Conf. Rep. No. 115-466 at 622-27 (Dec. 15, 2017).

11. *See* Toder, "International Competitiveness," *supra* note 2, at 8.

12. See chapter 5 for discussion of the Best Method Rule and the comparable uncontrolled price (CUP) and comparable profits method (CPM) methods of determining an arm's-length price.

13. *See* Treas. Reg. § 1.482-1(d)(3)(ii)(B); OECD Guidelines ¶¶ 1.52, 1.64–1.69.

14. See chapter 5 for discussion of the transaction-based and profits-based methods.

15. *See, e.g.*, Bausch & Lomb, Inc. v. Comm'r, 92 T.C. 525 (1989), *aff'd*, 923 F.2d 1084 (2d Cir. 1991) (finding that licensee/CFC had risks associated with pricing and volume of sales and therefore rejecting IRS's contract manufacturer theory); Sundstrand Corp. v. Comm'r, 96 T.C. 226 (1991) (same).

16. *See, e.g.*, Veritas Software Co. v. Comm'r, 133 T.C. No. 14 (2009) (rejecting IRS's platform intangibles theory in favor of pricing analysis based on comparable uncontrolled transactions (CUT)).

17. For example, in Eli Lilly Co. v. United States, 856 F.2d 855 (7th Cir. 1988), the court rejected the IRS's argument attacking outbound transfer of intangibles through 351 transactions but nevertheless sustained a portion of the IRS's adjustment. Similarly, in *Hosp. Corp. of Am.*, 81 T.C. at 601, Nonacquiescence by Commissioner at: Hospital Corp. of America, 1987-2 C.B. 1 (IRS 1987), the Tax Court rejected the IRS's theory that a transfer of a business opportunity was subject to Code § 482, but sustained a large portion of the IRS's adjustment on another, more fact-based theory regarding the value of services.