75.

United States

Introduction

This chapter is devoted to a broad outline of US transfer pricing rules and the accompanying penalty regulations. Also covered are the US Competent Authority procedures, including the Advance Pricing Agreement (APA) programme, and the interaction of the US rules with the Organisation for Economic Co-operation and Development (OECD) Guidelines.

The importance of the US rules on transfer pricing

The US regulatory environment is of great significance for a number of reasons:

- The US is an important market for the majority of multinational enterprises, and therefore compliance with US rules, which remain arguably the toughest and most comprehensive in the world, is a considerable issue in international business.
- Beginning in the 1990s, the US undertook a comprehensive reform of its transfer pricing regulations and has continued to update and expand legislation most recently with changes in the cost-sharing, services, and intangible property transfer areas. These developments tend to influence other countries to subsequently increase the stringency of their own rules. As such an understanding of developments in the US and the controversies surrounding them are good indicators of likely areas of contention in other countries.
- The US' aggressive transfer pricing regime has caused controversy with some of its trading partners, not all of whom have entirely agreed with the US' interpretation of the arm's-length standard. The regulations, together with a greater level of enforcement activity, have resulted in an increasing number of transfer pricing issues being considered through the competent authority process under the mutual agreement article of tax treaties concluded between the US and most of its major trading partners.
- The competent authority process also forms the basis for the APA programme, which has become a progressively more important mechanism for multinational enterprises to obtain prospective reassurance that their transfer pricing policies and procedures meet the requirements of the arm's-length standard as well as an additional mechanism for resolving tax audits involving transfer pricing issues.

Non-US tax authorities and practitioners alike have tended to be critical of the level of detail included in the US regulations and procedures. However, in considering the US regime, it is important to bear in mind that unlike many of its major trading partners, the US corporate tax system is a self-assessment system where the burden of proof is generally placed on the taxpayer – leading to a more adversarial relationship between the government and the taxpayer. This additional compliance burden placed on multinational enterprises by the US is not unique to the field of transfer pricing.

The rationale underlying the US regulations

In 1986, the US Congress ordered a comprehensive study of inter-company pricing and directed the Internal Revenue Service (IRS) to consider whether the regulations should be modified. This focus on transfer pricing reflected a widespread belief that multinational enterprises operating in the US were often setting their transfer prices in an arbitrary manner resulting in misstated taxable income in the US. Additional concerns were raised regarding the difficulty of the IRS to conduct retrospective audits to determine whether the arm's-length standard had been applied in practice due to the lack of documentation supporting the inter-company pricing schemes.

The history of the US reform process

Since 1934, the arm's-length standard has been used to determine whether cross-border, inter-company transfer pricing produces a clear reflection of income for US Federal income tax purposes. The arm's-length standard has become the internationally accepted norm for evaluating inter-company pricing.

In 1968, the IRS issued regulations that provided procedural rules for applying the arm's-length standard and specific pricing methods for testing the arm's-length character of transfer pricing results. These transaction-based methods, the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method, have gained broad international acceptance.

Congress amended § 482 in 1986, by adding the commensurate with income standard for the transfer of intangible property. At the same time, Congress directed the IRS to conduct a comprehensive study of inter-company transfer pricing, the applicable regulations under § 482 of the Code, and the need for new enforcement tools and strategies. The IRS responded to that directive by issuing the White Paper in 1988.

Between 1988 and 1992, Congress added or amended §§ 482, 6038A, 6038C, and 6503(k) to impose on taxpayers new information reporting and record-keeping requirements and to provide IRS Revenue Agents with greater access to that information. In addition, Congress added § 6662(e) and (h) to impose penalties for significant transfer pricing adjustments. In 1992, the IRS issued new proposed regulations under § 482. Those regulations implemented the commensurate with income standard and introduced significant new procedural rules and pricing methods. These proposed regulations also included significant new rules for cost-sharing arrangements.

In 1993, the IRS issued temporary regulations that were effective for taxable years beginning after 21 April 1993, and before 6 October 1994. These regulations emphasised the use of comparable transactions between unrelated parties and a flexible application of pricing methods to reflect specific facts and circumstances. The IRS also issued proposed regulations under § 6662(e) and (h), which conditioned the avoidance of penalties upon the development and maintenance of contemporaneous documentation showing how the pricing methods specified in the § 482 regulations had been applied.

In 1994, the IRS issued temporary and proposed regulations under § 6662(e) and (h), applicable to all tax years beginning after 31 December 1993. The IRS also issued final regulations under § 482, effective for tax years beginning after 6 October 1994 and amended the temporary and proposed § 6662(e) and (h) regulations, retroactive to 1 January 1994.

Also in 1994, final § 482 regulations were issued, which are generally effective for tax years beginning after 6 October 1994. However, taxpayers may elect to apply the final regulations to any open year and to all subsequent years.

In 1995, final regulations on cost-sharing were issued (which were subject to minor modification in 1996). These regulations were effective for taxable years beginning on or after 1 January 1996. Existing cost-sharing arrangements were not grandfathered and had to be amended to conform to the final regulations. If an existing cost-sharing arrangement met all of the requirements of the 1968 cost-sharing regulations, participants had until 31 December 1996 to make the required amendments. Major changes to the rules governing cost-sharing transactions were recommended on 22 August 2005, when the IRS issued proposed cost-sharing regulations. These proposed regulations focus on three new specified methods of valuation for determining the arm's-length buy-in amount and are described later in this chapter. At the writing of this chapter, the proposed regulations have not been finalised.

On 9 February 1996, final transfer pricing penalty regulations under § 6662 were issued with effect from that date subject to a taxpayer's election to apply them to all open tax years beginning after 31 December 1993. Revised procedures for APAs were also issued in 1996. In 1998 the IRS simplified and streamlined procedures for APAs for small-business taxpayers.

In 2003, regulations that were proposed in 2002 dealing with the treatment of costs associated with stock options in the context of qualifying cost-sharing arrangements (*see below*) were finalised, and regulations governing the provision of intragroup services were proposed. The proposed services regulations were replaced by temporary and proposed regulations (temporary regulations) issued on 31 July 2006. Finally, the new services regulations were made final on 31 July 2009.

Global dealing regulations which primarily impact the financial services sector are expected to clarify how to attribute profits consistent with the transfer pricing rules when a permanent establishment exists. At the writing of this chapter, these regulations have not been finalised.

On 13 February 2012 the Treasury released the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, also referred to as the 'Green Book'. The proposals include two items that could have a significant impact on outbound transfers of intangible property:

1. Tax Currently 'Excess' Returns Associated with Transfers of Intangibles Offshore.
2. Limit Shifting of Income Through Intangible Property Transfers.

The first proposal is a modified version of the proposal in last year's budget. The proposal would provide that if a US person transfers (directly or indirectly) an intangible from the US to a related controlled foreign corporation (a 'covered intangible'), then certain excess income from transactions connected with or benefitting from the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate. In the case of an effective tax rate of 10% or less, the proposal would treat all excess income as Subpart F income, and would then ratably phase out for effective tax rates of 10 to 15% percent. For this purpose, excess intangible income would be defined as the excess of gross income from transactions connected with or benefitting from such covered intangible over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up. For purposes of this proposal, the transfer of an intangible includes sale, lease, license, or any shared risk or development agreement (including any cost-sharing arrangement). This subpart F income will be a separate category of income for purposes of determining the taxpayer's foreign tax credit limitation under § 904. The second proposal is identical to the version presented in last year's budget. This proposal would clarify the definition of intangible property for purposes of §§ 367(d) and 482 to include workforce in place, goodwill and going concern value. The proposal also would clarify that where multiple intangible properties are transferred, the commissioner may value the intangible properties on an aggregate basis where that achieves a more reliable result. In addition, the proposal would clarify that the commissioner may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

A key factor influencing the future of US Federal corporate income tax policy, and in turn transfer pricing policy, will likely be the outcome of the 2012 US presidential election as the challenger to the current president has a different point of view with respect to corporate taxation than the current administration. The increasing popularity of the fiscal conservative movement among traditionally moderate voters as well as domestic concerns about inflation and unemployment will likely also play a role in electing the next US president and will ultimately influence US Federal corporate income tax policy.

Consistency between the US regulations and the OECD Guidelines

At the same time as the reform process was progressing in the US, the OECD was also revising its guidelines on transfer pricing (*see Chapter 3*). The OECD Guidelines are a significant point of reference for many of the US' major trading partners in dealing with transfer pricing issues. The extent to which the OECD Guidelines are consistent with the US approach is thus a critical issue for all multinational enterprises that wish to be in full compliance with local laws in all the jurisdictions in which they operate and at the same time mitigate the risk of double taxation and penalties. The substantive provisions of the US regulations are compared to the OECD Guidelines in this chapter (*see Comparison with the OECD Transfer Pricing Guidelines section, below*).

Statutory rules

Section 482 of the Internal Revenue Code of 1986 (as amended) provides that the Secretary of the Treasury has the power to make allocations necessary to "prevent evasion of taxes or clearly to reflect the income of…organizations, trades or businesses". It also provides that in respect of intangible property transactions, 'the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible'. Detailed Treasury Regulations promulgated under § 482 are the main source of interpretation of both the arm's-length standard and the commensurate with income standard.

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The US transfer pricing regulations

The Best Method Rule

A taxpayer must select one of the pricing methods specified in the regulations to test the arm's-length character of its transfer prices. Under the Best Method Rule, given the facts and circumstances of the transactions under review, the pricing method selected should provide the most reliable measure of an arm's-length result relative to the reliability of the other potentially applicable methods. In other words, while there may be more than one method which can be applied to a given set of facts and circumstances, the method that yields the most accurate, or best, result should be selected. The relative reliability of the various transaction-based pricing methods depends primarily upon:

- the use of comparable uncontrolled transactions and the degree of comparability between those transactions and the taxpayer's transactions under review, and
- the completeness and accuracy of the underlying data, and the reliability of the assumptions made and the adjustments required to improve comparability.

Adjustments must be made to the uncontrolled comparables if such adjustments will improve the reliability of the results obtained under the selected pricing method. Determination of the degree of comparability will be based on a functional analysis made to identify the economically significant functions performed, assets employed, and risks borne by the controlled and uncontrolled parties involved in the transactions under review.

Industry average returns cannot be used to establish an arm's-length result except in rare instances where it can be demonstrated that the taxpayer establishes its inter-company prices based on such market or industry indices and that other requirements are complied with. Unspecified methods may be used if it can be shown that they produce the most reliable measure of an arm's-length result. A strong preference is given to transactional (as opposed to profits-based) methods that rely on external data and comparable uncontrolled transactions. When using a specified method, a taxpayer is not required to demonstrate the inapplicability of other methods before selecting its preferred method. However, in order to avoid potential penalties, a taxpayer must demonstrate with contemporaneous documentation that it has made a reasonable effort to evaluate the potential applicability of other methods before selecting its best method (*see The US penalty regime section, below*).

The arm's-length range

No adjustment will be made to a taxpayer's transfer pricing results if those results are within an arm's-length range derived from two or more comparable uncontrolled transactions. This concept of a range of acceptable outcomes rather than a single arm's-length answer is the key to understanding the flexible application of the arm's-length standard that underlies the US regulations.

Under the regulations, the arm's-length range will be based on all of the comparables only if each comparable meets a fairly high standard of comparability. If inexact comparables are used, the range ordinarily will be based only on those comparables that are between the 25th and 75th percentile of results. However, other statistical methods may be used to improve the reliability of the range analysis.

If a taxpayer's transfer pricing results are outside the arm's-length range, the IRS may adjust those results to any point within the range. Such an adjustment will ordinarily be to the median of all the results.

The regulations permit comparisons of controlled and uncontrolled transactions based upon average results over an appropriate multiple-year period. If taxpayer's results are not within the arm's-length range calculated using multiple-year data the adjustment for a year may be based on the arm's-length range calculated using data from only that year.

Collateral adjustments and set-offs

A taxpayer is required to report an arm's-length result on its tax return, even if those results reflect transfer prices that are different from the prices originally set out on invoices and in the taxpayer's books and records, and may be subjected to substantial penalties if they fail to do so. This provision has no direct equivalent in the tax codes of most of the US major trading partners and may result in double taxation of income.

In the event of an income adjustment under § 482 involving transactions between US entities, the IRS is required to take into account any appropriate collateral adjustment. For example, should the income of one member of the controlled group be increased under § 482, other members must recognise a corresponding decrease in income. This should be distinguished from the treatment of both (1) adjustments involving other US domestic taxpayers outside the consolidated group where there is no requirement for the IRS to allow a corresponding deduction, and (2) foreign initiated adjustments where it will be necessary to invoke a Competent Authority process as the only means of obtaining a corresponding adjustment in the US (*see below*).

Taxpayers may also claim set-offs to the extent that it can be established that other transactions were not conducted at arm's length. The regulations limit such set-offs to transactions between the same two taxpayers within the same taxable year.

Impact of foreign legal restrictions

The regulations include provisions that attempt to limit the effect of foreign legal restrictions on the determination of an arm's-length price. In general, such restrictions will be taken into account only if those restrictions are publicly promulgated and affect uncontrolled taxpayers under comparable circumstances. The taxpayer must demonstrate that it has exhausted all remedies prescribed by foreign law, the restrictions expressly prevent the payment or receipt of the arm's-length amount, and the taxpayer (or the related party) did not enter into arrangements with other parties that had the effect of circumventing the restriction. The regulations also attempt to force the use of the deferred income method of accounting where foreign legal restrictions do limit the ability to charge an arm's-length price.

Transfers of tangible property

The regulations governing the transfer of tangible property have not changed substantially since 1992. They continue to focus on comparability of products under the CUP method, and the comparability of functions under the resale price and cost plus methods. Comparability adjustments under the regulations must consider potential differences in quality of the product, contractual terms, level of the market, geographic market, date of the transaction and other issues. In addition, the regulations require consideration of potential differences in business experience and management efficiency.

Transfers of intangible property

The implementation of the commensurate with income standard has been a considerable source of controversy between the US and its trading partners. Some have interpreted the intent of the regulations to be the consideration for the transfer of an intangible asset, which is subject to adjustment long after the transfer takes place. This approach has been viewed as inconsistent with the way unrelated parties would interact with one another. The primary objective of this provision is to ensure that the IRS has the right to audit the reliability of the assumptions used in setting the transfer price for an intangible asset to determine whether the transfer had been made at arm's length. As such, the regulations provide a detailed description of how the consideration paid for an intangible asset will be evaluated consistent with the statutory requirement that the consideration be commensurate with the income derived from exploitation of the intangible.

In general terms, the need for periodic adjustment to transfer prices for intangible property depends upon whether the transfer pricing method used to set the transfer price relies on projected results (projected profit or cost savings). No periodic adjustments will be required if the actual cumulative benefits realised from exploitation of the intangible are within a range of plus or minus 20% of the forecast. If the actual benefits realised fall outside this range, the assumption is that the transfer price will be re-evaluated unless any of the further extraordinary event exceptions detailed in the regulations are satisfied. The intent behind these regulations is to replicate what would occur in a true third party relationship if, for example, one party to a licence arrangement found that unanticipated business events made the level of royalty payments economically not viable. It also prevents a taxpayer from manipulating a forecast of benefits that would result in a significantly different purchase price for the intangible.

If no adjustment is warranted for each of the five consecutive years following the transfer, the transfer will be considered to be at arm's length and consequently no periodic adjustments will be required in any subsequent year. If an adjustment is warranted, there have been recent debates as to whether a taxpayer can affirmatively invoke the commensurate with income standard. Under the 2003 proposed cost-sharing regulations, the IRS posits that only the commissioner has the right to invoke the commensurate with income standard and not the taxpayer.

All prior regulations (including those issued in 1968, 1992 and 1993, respectively) provided that, for transfer pricing purposes, intangible property generally would be treated as being owned by the taxpayer that bore the greatest share of the costs of development of the intangible. In contrast, the 1994 final regulations provide that if an intangible is legally protected (e.g. patents, trademarks, and copyrights) the legal owner of the right to exploit an intangible ordinarily will be considered the owner for transfer pricing purposes. In the case of intangible property that is not legally protected (e.g. know-how) the owner continues to be the party that bears the greatest share of the costs of development.

The regulations provide that legal ownership of an intangible is determined either by operation of law or by contractual agreements under which the legal owner has transferred all or part of its rights in the intangible to another party. In determining legal ownership of the intangible, the final regulations provide that the IRS may impute an agreement to convey ownership of the intangible if the parties' conduct indicates that, in substance, the parties have already entered into an agreement to convey legal ownership of the intangible.

The temporary regulations issued on 1 July 2006 maintained the 1994 final regulations' treatment for legally protected intangibles (i.e. the legal owner of the rights to exploit an intangible ordinarily will be considered the owner for transfer pricing purposes). However, the temporary regulations redefined the definition of ‘owner’ (for transfer pricing purposes) of intangible property rights that are not legally protected. Unlike the existing regulations which assigns ownership of such intangibles to the party that bears the largest portion of the costs of development, the temporary regulations redefine the owner of such intangibles as the party that has the ‘practical control’ over the intangibles. Therefore, eliminating the old ‘developer-assister’ rule altogether.

Given this position, the possibility still exists that there may be a difference of opinion between the US and other taxing jurisdictions as to whom the primary owner of some categories of intangible assets may be for transfer pricing purposes. For example, taxpayers may find that because proprietary rights strategies can vary from country to country, the treatment of intangibles may not be consistent across countries, even though the economic circumstances are the same. Taxpayers may also find that trademarks are deemed owned by one party, while the underlying product design and specifications are deemed owned by a different party. Multinational corporations should take these potential differences of opinion into account in planning their inter-company pricing policies and procedures.

The IRS has provided rules for determining how the commensurate with income standard should be applied to lump-sum payments. Such payments will be arm’s length and commensurate with income if they are equal to the present value of a stream of royalty payments where those royalty payments can be shown to be both arm’s length and commensurate with income.

In February 2007, the IRS issued an Industry Directive indicating the likely direction that future IRS audits will take with regard to migrations of intangible property. The Industry Directive primarily targets pharmaceutical and other life sciences companies that transferred the operations of former § 936 possessions corporations to controlled foreign corporations, or CFCs. More broadly, the Industry Directive underscores the attention that the IRS has been paying to issues surrounding intangible migration transactions. On 27 September 2007, the IRS issued Coordinated Issue Paper (LMSB-04-0907-62) addressing buy-in payments associated with cost-sharing arrangements. The CIP covers all industries, suggesting that the IRS is preparing to more rigorously analyse and examine the key operations and risks related to the migration of intangible assets going forward. On 19 January 2012, IRS Transfer Pricing Director Samuel Maruca announced that the CIP would be withdrawn. The withdrawal of the CIP is mostly a formality as the final cost-sharing regulations were issued on 16 December 2011 (*see Cost-sharing, below*).

Intangibles embedded in the provision of intragroup services

In July 2006, the Treasury Department and IRS issued temporary and proposed regulations governing the provision of intragroup services. Following a protracted period of public commentary and a transition phase, new services regulations were issued on 31 July 2009.

The new regulations emphase the interaction between intragroup services and the use of intangible property and provide numerous examples of situations where a provider of intragroup services would earn higher margins, or could be expected to share in the profits of the development of intangible property that is jointly developed by the owner of the property and the service provider. Research and development (R&D), and the development of marketing intangible assets in a local market, are examples of high-value services provided in conjunction with intangible property.

The comparable profits method

The comparable profits method (CPM) may be used to test the arm's-length character of transfers of both tangible and intangible property. The CPM evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability, known as 'profit level indicators', derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. Differences in functions performed, resources used, and risks assumed between the tested party and the comparables should be taken into account in applying this method.

Profit split methods

Profit split methods are specified methods for testing the arm's-length character of transfers of both tangible and intangible property. However, the emphasis on comparable transactions throughout the regulations is intended to limit the use of profit split methods to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable uncontrolled comparables under some other method. Profit split methods are appropriate when both parties to a transaction own valuable non-routine intangible assets.

Specified profit split methods are limited to either (1) the comparable profit split method which makes reference to the combined operating profit of two uncontrolled taxpayers dealing with each other and whose transactions are similar to those of the controlled taxpayer, or (2) the residual profit split method, which allocates income first to routine activities using any of the other methods available and then allocates the residual income based upon the relative value of intangible property contributed by the parties. No other profit split methods are treated as specified methods under the final regulations (although other forms of profit splits might be used, if necessary, as unspecified methods). The temporary regulations expanded the potential applications of the residual profit split method. Whereas under the existing regulations the residual profit is split between the parties that contribute valuable non-routine intangibles, the temporary regulations suggest the residual profits can be split between parties that provide non-routine contributions (not necessarily intangibles) to the commercial venture.

Cost-sharing

The US cost-sharing regulations

On 16 December 2011, the Internal Revenue Service (IRS) and the Treasury Department issued final cost-sharing regulations (Final Regulations) that were previously issued as temporary and proposed regulations (2008 Temporary Regulations) on 31 December 2008, providing guidance on the treatment of cost-sharing arrangements (CSAs). The Final Regulations largely continue the guidance contained in the 2008 Temporary Regulations, which were set to expire on 30 December 2011. Subsequently, on 19 December 2011, the IRS and Treasury Department issued additional cost-sharing rules in the form of temporary regulations (2011 Temporary Regulations), which provide further guidance on the evaluation of discount rates in applying the income method. At the same time, the IRS and Treasury Department also issued proposed regulations (2011 Proposed Regulations), which propose to include a new specified application of the income method based on the use of the 'differential income stream'.

The Final Regulations are applicable commencing on 16 December 2011, the date they were filed with the Federal Register, and are generally applicable to all CSAs with a continuation of the transition rules in the 2008 Temporary Regulations that apply to CSAs in existence on 5 January 2009. The 2011 Temporary Regulations are effective as of 19 December 2011. The comment period for the 2011 Proposed Regulations closed on 21 March 2012, 90 days following their publication in the Federal Register.

Determining platform contribution transactions

The 2008 Temporary Regulations introduced five specified methods for valuing cost-sharing buy-ins, now referred to as Platform Contribution Transactions (PCTs) and provide guidance on the use of the Best Method Rule in determining the value of PCTs. These specified methods include the comparable uncontrolled transaction (CUT) method, income method, acquisition price method, residual profit split method, and market capitalisation method. In addition, the 2008 Temporary Regulations confirmed the use of the arm's-length range in determining the value of PCTs.

The 2008 Temporary Regulations also significantly changed the application of the 'Investor Model', a concept introduced in the proposed regulations issued in August 2005 (August 2005 Proposed Regulations). The Investor Model assesses the reliability of a method based on its consistency with the assumption that the rate of return anticipated at the date of a PCT for both the licensor and licensee must be equal to the appropriate discount rate for the CSA activity. Furthermore, this model indicates that the present value of the income attributable to the CSA for both the licensor and licensee must not exceed the present value of income associated with the best realistic alternative to the CSA. In the case of a CSA, the 2008 Temporary Regulations indicated that such an alternative is likely to be a licensing arrangement with appropriate adjustments for the different levels of risk assumed in such arrangements.

Through the 2008 Temporary Regulations, the IRS recognised that discount rates used in the present value calculation of PCTs can vary among different types of transactions and forms of payment.

While the Final Regulations generally adopt the principals and transfer pricing methods described in the 2008 Temporary Regulations to value a platform contribution, and in particular the reliance on the investor model, the Final Regulations provide further clarification on the parameters used in the application of the specified methods, such as tax rates and discount rates. The Final Regulations clarify that the 'tax rate' for purposes of determining amounts on a pre-tax basis refers to the 'reasonably anticipated effective rate with respect to the pre-tax income to which the tax rate is being applied (PCT Payor or PCT Payee)'.

Definition of intangibles and intangible development area

The scope of the intangible development area under the 2008 Temporary Regulations was meant to include all activities that could reasonably be anticipated to contribute to the development of the cost-shared intangibles. To that end, the 2008 Temporary Regulations stated that the intangible development area must not merely be defined as a broad listing of resources or capabilities to be used and introduced the concept that any 'resource, right or capability' – including resources contributed in the form of services, for example – must be compensated. The Final Regulations ensure that this concept is consistently reflected throughout the regulatory language by referring to 'resource, capability or right' rather than 'intangibles' as in the 2008 Temporary Regulations.

The 2008 Temporary Regulations also broadened the scope of external contributions that must be compensated as PCTs to include the value of services provided by a research team. Such a team would represent a PCT for which a payment is required over and above the team's costs included in the cost-sharing pool. This concept is maintained in the Final Regulations.

Periodic adjustments

A significant change in the 2008 Temporary Regulations, which remains unchanged in the Final Regulations, was the so-called 'periodic adjustment' rule which allows the IRS (but not the taxpayer) to adjust the payment for the PCT based on actual results. Unlike the 'commensurate with income' rules the 2008 Temporary Regulations provided a cap on the licensee's profits (calculated before cost-sharing or PCT payments) equal to 1.5 times its 'investment'. (For this purpose, both the profits and 'investment' are calculated on a present value basis.) That is, if the licensee 'profit' is in excess of 1.5 times its PCT and cost-sharing payments on a present value basis, an adjustment is made using the 2008 Temporary Regulations' version of the residual profit split method. In the example in the 2008 Temporary Regulations, this adjustment leaves the licensee with a 10% markup on its non-cost-sharing (non-R&D) expenses leaving it with only a routine return. Notably, this periodic adjustment is waived if the taxpayer concludes an APA with the IRS on the PCT payment. The Final Regulations also added a third example providing guidance on applying the periodic adjustment when more than two parties are involved in a CSA requiring multiple periodic adjustments each year.

There is also an exception for 'grandfathered' CSAs, whereby the periodic adjustment rule of the 2008 Temporary Regulations is applied only to PCTs occurring on or after the date of a 'material change' in scope of the intangible development area (but *see below for additional commentary*). The 2008 Temporary Regulations also provide exceptions to the periodic adjustment rule in cases where the PCT is valued under a CUT method involving the same intangible and in situations where results exceed the periodic adjustment cap due to extraordinary events beyond control of the parties.

Transition rules

The Temporary Regulations specify that cost-sharing arrangements in place on or before 5 January 2009 must meet certain administrative requirements in order to continue to be treated as CSAs.

The Temporary Regulations indicate that PCT payments made under CSAs in existence on or before 5 January 2009 will not be subject to the periodic adjustment rules described above, but rather will be governed by the commensurate with income adjustment rules. However, there is an exception for PCTs occurring on or after a material change in scope in the CSA which includes 'a material expansion of the activities undertaken beyond the scope of the intangible development area'. A determination of 'material change in scope' is made on a cumulative basis such that a number of smaller changes may give rise to a material change in the aggregate. In addition, grandfathered CSAs are not subject to the requirement of non-overlapping and exclusive divisional interests.

Reasonably Anticipated Benefit Shares

The 2008 Temporary Regulations made an important change to the requirements under which Reasonably Anticipated Benefit (RAB) ratios are calculated for cost-sharing arrangements. There is now an explicit requirement that RAB ratios be computed using the entire period of exploitation of the cost-shared intangibles. The

Final Regulations include new language that explicitly prohibits any retroactive change to RAB shares for prior years based on updated information regarding relative benefits that was not available in the prior year.

Services regulations

The US services regulations

US services regulations were originally issued in 1968, and included the cost safe harbour rule allowing certain services to be charged at cost. On 10 September 2003, the IRS proposed new proposed regulations for the treatment of controlled services transactions, which included a new cost method, the Simplified Cost Based Method (SCBM), introduction of shared services arrangements, and required stock based compensation to be included in the pool of total services costs.

On 4 August 2006, the IRS issued new temporary and proposed services regulations in response to practitioners' feedback from the 2003 proposed regulations. As anticipated, the IRS and Treasury issued final § 482 regulations on 31 July 2009 effective as of that date and applying to taxable years beginning after that date. These regulations provide guidance regarding the treatment of controlled services transactions under § 482 and the allocation of income from intangible property. Additionally, these regulations modify the final regulations under § 861 concerning stewardship expenses to be consistent with the changes made to the regulations under § 482.

Controlled taxpayers may elect to apply retroactively all of the provisions of these regulations to any taxable year beginning after 10 September 2003. Such election will be effective for the year of the election and all subsequent taxable years.

The final service regulations require taxpayers to apply the arm's-length standard in establishing compensation amounts for the provision of inter-company services. Thus, similar to other sections of the transfer pricing regulations, taxpayers involved in the provision of inter-company services must adhere to the best method, comparability, and the arm's-length range requirements of Treas. Reg. § 1.482-1. What is new is that the final service regulations stipulate that taxpayers must apply one of the six specified transfer pricing methods or an unspecified method in evaluating the appropriateness of their inter-company services transactions. The six specified transfer pricing methods include three transactional approaches, two profit-based approaches, and a cost-based safe harbour. The transactional approaches are the comparable uncontrolled services price method (CUSPM), the gross services margin method (GSMM) and the cost of services plus method (CSPM). The two profit-based approaches are the existing comparable profits method (CPM) and the profit split method (PSM). The cost-based safe harbour is the services cost method (SCM).

Services cost method (SCM)

The new services regulations, consistent with the 2006 regulations, include the SCM which replaced the previously proposed SCBM. Taxpayers employing the SCM must state their intention to apply this method to their services in detailed records that are maintained during the entire duration that costs relating to such services are incurred. The records must include all parties involved (i.e. renderer and recipient) and the methods used to allocate costs.

The new regulations make certain clarifying changes to the provisions dealing with the SCM. The final regulations incorporate the clarifications and changes previously issued in Notice 2007-5, 2007-1 CB 269. Aside from these changes and certain other minor, non-substantive modifications, the provisions in the final regulations relating to the SCM and other transfer pricing methods applicable to controlled services transactions are essentially the same as those in the temporary regulations.

In addition to the good list and the low-margin services, a taxpayer must also comply with the Business Judgment Rule, which was effective for taxable years beginning after 31 December 2006 under the proposed and temporary services regulations. This rule requires taxpayers to conclude that the services do not contribute significantly to key competitive advantages, core capabilities, or fundamental chances of success or failure in one or more trades or business of the renderer, the recipient, or both.

Consequently, like the temporary regulations, the final regulations provide that services may qualify for the SCM only if they are either 'specified covered services' as described in Revenue Procedure 2007-13, 2007-1 C.B. 295, or are services for which the median arm's-length markup is 7% or less. In addition, the services must continue to satisfy the Business Judgment Rule, which in the final regulations is consistent with the temporary regulations as clarified by Notice 2007-5. With respect to 'specified covered services' that may be eligible for SCM, the IRS and Treasury believe that the list of specified covered services issued in Revenue Procedure 2007-13 is generally appropriate, although they will consider recommendations for additional services to be added to the list in the future.

The regulations also specifically mention services where the SCM cannot be employed, these services include:

- Manufacturing.
- Production.
- Extraction, exploration or processing of natural resources.
- Construction.
- Reselling, distribution, acting as sales or purchasing agent, or acting under a commission or similar arrangement R&D or experimentation.
- Financial transactions, including guarantees.
- Insurance or reinsurance.

The comparable uncontrolled services price method (CUSPM)
The CUSPM is analogous to the comparable uncontrolled price (CUP) and the comparable uncontrolled transaction (CUT). Under the CUSPM, the price charged in a comparable uncontrolled services transactions form the basis of evaluating the appropriateness of the controlled services transaction. Generally, the CUSPM is applicable in situations where the related party services are similar (or have a high degree of similarity) to the comparable uncontrolled services transactions.

The gross services margin method (GSMM)
The GSMM is comparable to the resale price method (RPM) of the tangible property transfer pricing regulations. Under this method, evaluating the appropriateness of inter-company services pricing arrangements relies on the gross profit margins earned in comparable uncontrolled services transactions as benchmarks. The GSMM is appropriate in situations where a controlled taxpayer provides services (e.g. agency or intermediary services) in connection with a related uncontrolled transaction involving a member of the controlled group and a third party.

The cost of services plus method (CSPM)

The CSPM is analogous to the cost plus (CP) method of the tangible property transfer pricing regulations. Like the CP method, the CSPM evaluates the appropriateness of inter-company services transfer pricing arrangements by reference to the gross services profit markup earned in comparable uncontrolled services transactions. The CSPM is appropriate when the service providing entity provides the same or similar services to both related and third parties.

Contractual arrangements and embedded intangibles

In analysing transactions involving intangible property, the new services regulations have retained the emphasis on the importance of legal ownership. When intangible property is embedded in controlled services transactions, the economic substance must coincide with the contractual terms and must be in accord with the arm's-length standard.

Ownership of intangibles

The new services regulations have issued new guidance surrounding the ownership of intangibles. For transfer pricing purposes, the owner for legally-protected intangibles is the legal owner. However, in the case of non-legally protected intangibles, the owner is the party with 'practical control' over the intangible. When the legal ownership standard is inconsistent with 'economic substance,' these rules may be dismissed. The new services regulations eliminate the possibility of multiple ownership of a single intangible as was the case under the 'developer-assister' rule in the prior regulations.

The final regulations continue without significant change in the provisions of the temporary regulations for identifying the owner of an intangible for transfer pricing purposes, and for determining the arm's-length compensation owing to a party that contributes to the value of an intangible owned by another controlled party. Thus, the final regulations reflect the continuing view of the IRS and Treasury that legal ownership provides the appropriate framework for determining ownership of intangibles. The legal owner is the controlled party that possesses legal ownership under intellectual property law or that holds rights constituting an intangible pursuant to contractual terms (such as a license), unless such ownership is inconsistent with the economic substance of the underlying transactions.

Benefit test

An activity provides a benefit if it directly results in a reasonably identifiable increment of economic or commercial value to the service recipient. The final services regulations look at benefit primarily from the service recipient's perspective.

The final service regulations permit the sharing or allocation of centralised service activities or corporate headquarters costs only in situations in which there is an identifiable benefit to the recipients attributed to the charged-out costs. The final services regulations states that activities that provide only an indirect or remote benefit, duplicative activities, shareholder activities, and passive association are not beneficial services for recipients. Thus, recipients are not liable for such costs under the service regulations.

Pass-through costs

The new regulations further clarify the rules for 'pass-through' of external costs without a markup. This generally applies to situations in which the costs of a controlled service provider include significant charges from uncontrolled parties. Rather than have these costs permitted to 'pass-through' and not be subject to a markup under the transfer pricing method used to analyse the controlled services transaction, the new regulations allow for the evaluation of the third party costs (if material) to be evaluated on a disaggregated basis from the covered service transaction.

Passive association benefits

A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, is taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

Stewardship and shareholder activities

The final regulations continue without significant change the provisions of the temporary regulations dealing with 'stewardship expenses'. These provisions include the provisions under the § 482 regulations for determining whether an activity constitutes a service to a related party for which arm's-length compensation is due, or instead constitutes solely a stewardship activity. They also include the related regulatory provisions under § 861 dealing with the allocation and apportionment of expenses. As noted above, like the temporary regulations, the final regulations under Treas. Reg. § 1.861-8(e)(4) concerning stewardship expenses have been modified to be consistent with the language relating to controlled services transactions in Treas. Reg. § 1.482-9(l). Stewardship expenses, which are defined in the final regulations as resulting from 'duplicative activities' or 'shareholder activities' (as defined in Treas. Reg. § 1.482-9(l)), are allocable to dividends received from the related corporation. The final regulations maintain the narrowed definition of 'shareholder activities' that includes only those activities whose 'sole effect' (rather than 'primary effect') is to benefit the shareholder. Examples:

- Preparation and filing of public financial statements.
- Internal Audit activities.

Stewardship activities were previously defined under the Temporary Regulations as an activity by one member of a group of controlled taxpayers that results in a benefit to a related member. These services would be allocated and charged out to the group members. Examples:

- Expenses relating to a corporate reorganisation (including payments to outside law firms and investment bankers) could require a charge depending on the application of the benefit test.
- Under the temporary regulations, the IRS may require US multinationals to charge for many centralised group services provided to foreign affiliates.
- Activities in the nature of day-to-day management of a controlled group are explicitly excluded from the category of shareholder expenses because the temporary regulations do not view such expenses as protecting the renderer's capital investment.

Stock-based compensation

The IRS received a number of comments on the regulatory provision that requires stock-based compensation to be included in 'total services costs' for purposes of the SCM. Some commentators requested further guidance on valuation, comparability, and reliability considerations for stock-based compensation, while others objected to the statement that stock-based compensation can be a services cost. On this somewhat controversial issue, the IRS and Treasury deferred consideration of the comments. The Preamble to the final regulations states: "These final regulations do not provide further guidance regarding stock-based compensation. The Treasury Department and the IRS continue to consider technical issues involving stock-based compensation in the services and other contexts and intend to address those issues in a subsequent guidance project".

Shared services arrangements

The new regulations provide guidance on the Shared Services Arrangements (SSAs), which applies to services that otherwise qualify for the SCM, i.e. are not subject to a markup. Costs are allocated based on each participant's share of the reasonably anticipated benefits from the services with the actual realisation of benefit bearing no influence on the allocation. The taxpayer is required to maintain documentation stating the intent to apply the SCM for services under an SSA.

Financial guarantees

Financial guarantees are excluded as eligible services for application of the SCM because the provision of financial transactions including guarantees requires compensation at arm's length under the temporary regulations.

Economic substance, realistic alternatives, and contingent payment services

The final regulations are consistent with the temporary regulations regarding the IRS's authority to impute contractual terms to be consistent with the economic substance of a related-party transaction, including the provisions addressing contingent payment services transactions. Provisions authorising the IRS to consider realistic alternatives in evaluating the pricing of controlled services transactions also remain unchanged. The Preamble to the final regulations, and certain clarifying changes to the regulatory language, emphasise that the evaluation of economic substance must be based on the transaction and risk allocation actually adopted by the related parties and based on the actual conduct of the parties, and that IRS is not authorised to impute a different agreement solely because there is a dispute regarding the transfer pricing of the transaction. In addition, the Preamble emphasises that the 'realistic alternatives' principle does not permit the IRS to recast a controlled transaction as if the alternative transaction had been adopted, but rather permits the IRS only to consider alternatives in evaluating what price would have been acceptable to a controlled party.

Documentation requirements

The new regulations do not require documentation to be in place prior to the taxpayer filing the tax return. However, documentation prepared after the tax return is filed would not provide for penalty protection in the event the IRS disagrees with the application of the method used.

Legal cases

There are a number of significant settled, decided and pending litigation matters involving transfer pricing issues in the US. In the last decade the following three cases have attracted particular attention.

- *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, 117 T.C. No. 1 (2001).The issue of development of marketing intangibles is at the core of the GlaxoSmithKline plc (Glaxo) Tax Court case. In September 2006, the IRS announced the resolution of the case, the largest tax dispute in the agency's history. The parties reached a settlement under which Glaxo agreed to pay the IRS approximately 3.4 billion United Sates dollars (USD). According to the IRS claims, drugs marketed by the UK multinational Glaxo through a US affiliate derived their primary value from marketing efforts in the US rather than from R&D owned in the UK. The IRS's position is that the unique nature of the R&D may explain the success of the first drug of its kind; however, subsequent market entrants are successful primarily because of the marketing acumen of the US affiliate. Consequently, the IRS asserted that the rate Glaxo's US affiliate charged to its UK parent for marketing services was too low. Furthermore, it argues that the 'embedded' marketing intangibles, trademarks, and trade names existed and were economically owned by the US affiliate. The IRS adjusted the transfer prices paid by the US affiliate to its parent to a contract manufacturing markup on costs and reduced the royalties paid by the US affiliate for the right to sell the product. Emphasising the US affiliate's contribution to enhancing the value of the intangibles, the IRS applied the residual profit split method, resulting in a majority of the US affiliate's profits being allocated to the US. Some tentative observations may be made as to what the implications of both the Glaxo case and the temporary regulations may be in the analysis of the use of marketing intangibles for transfer pricing purposes. The approach proposed by the IRS under the temporary regulations (and the new services regulations), as well as in the Glaxo case, might in the future suggest greater reliance by the IRS on profit split methods where a high value could arguably be attached to marketing services. With the heightened importance of these issues arising from a US perspective, tax authorities from other countries may also seek to employ a similar approach in determining the appropriate return for marketing and distribution functions performed by affiliates of foreign companies, especially where these issues are not contractually addressed by the parties.

- *Veritas Software Corporation v. Commissioner*, 133 T.C. No. 14 (2009). In Veritas, the IRS asserted taxpayer's calculation of the lump-sum buy-in payment for the transfer of intangibles between taxpayer's US entity and its Irish entity was incorrect and determined tax deficiencies of USD 704 million and USD 54 million, and § 6662 penalties of USD 281 million and USD 22 million, relating to 2000 and 2001, respectively. In taking its very aggressive position with respect to the valuation of the transferred intangibles, the IRS relied extensively on the report and trial testimony of its expert economist. However, the report and trial testimony demonstrated a lack of understanding of the applicable law and cited regulations not in effect at the time of the transactions under review. The Tax Court found in favour of the taxpayer. The key lesson to be learned from this case is the importance of identifying and applying the relevant rules and regulations to the facts and circumstances at hand given the IRS' targeting transactions involving the transfer of intangible property.
- *Xilinx v. Commissioner*, No. 06-74246 (9th Cir. Mar. 22, 2010). This extensively litigated case deals with the treatment of stock option costs in cost-sharing arrangements before the Temporary Regulations explicitly required the inclusion of these costs. In 2005, the US Tax Court rejected the IRS's assertion that taxpayer had to include employee stock option deductions in the cost base of its cost-sharing arrangement despite the fact that unrelated parties acting at arm's length would not bear such costs. In May 2009 a 3-judge panel of the 9th Circuit reversed the Tax Court. In January 2010 the 9th Circuit's ruling was withdrawn, apparently following a request for rehearing by the taxpayer. On rehearing the case, the same 3-judge panel of the 9th Circuit reversed their earlier decision and sided with

taxpayer. The Xilinx case highlights the continued focus of the IRS on cost-sharing arrangements and the importance of documentation and calculation support by taxpayers.

Burden of proof

The administration of matters related to transfer pricing in the US is based on the principle that the corporate income tax system relies on self-assessment and that consequently the burden of proof is on the taxpayer.

Tax audits

The IRS has extensive resources available to pursue field audits, at the appellate level and in competent authority procedures, including agents specially trained in economic analysis. Transfer pricing audits are not limited to cases where avoidance is suspected.

Multinational entities should expect to be called upon to affirmatively demonstrate how they set their inter-company prices and why the result is arm's length as part of the standard review of their US tax returns. Requests to produce supporting documentation within 30 days have become a standard feature of the commencement of such examinations.

The US penalty regime

The final penalty regulations

The IRS has stated that the objective of the penalty regime is to encourage taxpayers to make reasonable efforts to determine and document the arm's-length character of their inter-company transfer prices. The regulations provide guidance on the interpretation of 'reasonable efforts'.

With respect to transfer pricing, the transactional penalty applies to individual transactions in which the transfer price is determined not to be arm's length by the IRS. The regulations impose a 20% non-deductible transactional penalty on a tax underpayment attributable to a transfer price claimed on a tax return that is 200% or more, or 50% or less than the arm's-length price. The penalty is increased to 40% if the reported transfer price is 400% or more, or 25% or less than the arm's-length price. Where these thresholds are met, the transfer pricing penalty will be imposed unless the taxpayer can demonstrate reasonable cause and good faith in the determination of the reported transfer price.

In certain instances, based on the sum of all increases and decreases in taxable income which results from a series of transactions in which the transfer price is determined by the IRS to not be arm's length a net adjustment penalty may apply. A 20% net adjustment penalty is imposed on a tax underpayment attributable to a net increase in taxable income caused by a net transfer pricing adjustment that exceeds the lesser of USD 5 million or 10% of gross receipts. The penalty is increased to 40% if the net transfer pricing adjustment exceeds USD 20 million or 20% of gross receipts. Where these thresholds are met, the transfer pricing penalty can be avoided only if a taxpayer can demonstrate that it had a reasonable basis for believing that its transfer pricing would produce arm's-length results, and that appropriate documentation of the analysis upon which that belief was based existed at the time the relevant tax return was filed and is turned over to the IRS within 30 days of a request. The principal focus of the transfer pricing regulations is on these documentation requirements that must be met if a taxpayer is to avoid the assessment of a net adjustment penalty.

Under this penalty regime, it is entirely possible that a taxpayer could be assessed a transactional penalty but no net adjustment penalty at one end of the spectrum, or could be assessed a net adjustment penalty but no transaction penalty at the other. However, only one penalty, at the highest applicable rate, will be applied. The same underpayment in taxes will not be penalised twice. Regardless of the penalty, whether an underpayment of tax is attributable to non-arm's-length transfer pricing is determined from the results reported on an income tax return without consideration as to whether those reported results differ from the transaction prices initially reflected in a taxpayer's books and records. An amended tax return will be used for this purpose if it is filed before the IRS has contacted the taxpayer regarding an examination of the original return. A US transfer pricing penalty is not a no fault penalty. Even if it is ultimately determined that a taxpayer's transfer prices were not arm's length and the thresholds for either the transactional penalty or net adjustment penalty are met, a penalty will not be imposed if the taxpayer can demonstrate that based upon reasonably available data, it had a reasonable basis for concluding that its analysis of the arm's-length character of its transfer pricing was the most reliable, and that it satisfied the documentation requirements set out in the new final regulations.

The US Competent Authority has stated that transfer pricing penalties will not be subject to negotiation with tax treaty partners in connection with efforts to avoid double taxation.

The reasonableness test

A taxpayer's analysis of the arm's-length character of its transfer pricing will be considered reasonable if the taxpayer selects and applies in a reasonable manner a transfer pricing method specified in the transfer pricing regulations. To demonstrate that the selection and application of a method was reasonable, a taxpayer must apply the Best Method Rule and make a reasonable effort to evaluate the potential application of other specified pricing methods. If a taxpayer selects a transfer pricing method that is not specified in the regulations, the taxpayer must demonstrate a reasonable belief that none of the specified methods was likely to provide a reliable measure of an arm's-length result, and that the selection and application of the unspecified method would provide a reliable measure of an arm's-length result.

In applying the Best Method Rule, the final regulations make it clear that ordinarily it will not be necessary to undertake a thorough analysis under every potentially applicable method. The final regulations contemplate that in many cases the nature of the available data will readily indicate that a particular method will or will not likely provide a reliable measure of an arm's-length result. Thus, a detailed analysis of multiple transfer pricing methods should not be necessary except in unusual and complex cases.

The regulations specify that the following seven factors should be considered in determining whether a taxpayer's selection and application of a transfer pricing method has been reasonable:

1. The experience and knowledge of the taxpayer and its affiliates.
2. The availability of accurate data and the thoroughness of the taxpayer's search for data.
3. The extent to which the taxpayer followed the requirements of the transfer pricing regulations.

4. The extent to which the taxpayer relied upon an analysis or study prepared by a qualified professional.
5. Whether the taxpayer arbitrarily sought to produce transfer pricing results at the extreme point of the arm's-length range.
6. The extent to which the taxpayer relied on an advance pricing agreement applicable to a prior tax year, or a pricing methodology specifically approved by the IRS during an examination of the same transactions in a prior year.
7. The size of a transfer pricing adjustment in relation to the magnitude of the inter-company transactions out of which the adjustment arose.

In determining what level of effort should be put into obtaining data on which to base a transfer pricing analysis, a taxpayer may weigh the expense of additional research against the likelihood of finding new data that would improve the reliability of the analysis. Taxpayers are not required to search for relevant data after the end of the tax year but are required to retain any relevant data that is in fact acquired after the year-end but before the tax return is filed.

The contemporaneous documentation requirement
To avoid a transfer pricing penalty, a taxpayer must maintain sufficient documentation to establish that it reasonably concluded that, given the available data, its selection and application of a pricing method provided the most reliable measure of an arm's-length result and must provide that documentation to the IRS within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates.

The announcement by the commissioner of the IRS Large Business and International (formerly Large and Midsize Business) Division (on 23 January 2003) indicates that the IRS is stepping up enforcement of the 30-day rule and adopting a standard practice of requiring field examiners to request a taxpayer's contemporaneous documentation within 30 days at the commencement of every examination of a taxpayer with significant inter-company transactions.

There is no requirement to provide any documentation to the IRS in advance of such a request and the tax return disclosure requirements relating to the use of unspecified methods, the profit split method and lump-sum payments for intangibles originally included in the 1993 temporary regulations were not retained in the final regulations. In this respect, the US regime is less onerous than some other jurisdictions (e.g. Canada Australia, and India). However, in contrast, it should be noted that the IRS apparently is enforcing tax return disclosure requirements relating to the existence of cost-sharing arrangements (*see above*).

Principal documents
To meet this documentation requirement the following principal documents which must exist when the relevant tax return is filed should accurately and completely describe the basic transfer pricing analysis conducted by a taxpayer:

- An overview of the taxpayer's business, including an analysis of economic and legal factors that affect transfer pricing.
- A description of the taxpayer's organisational structure, including an organisational chart, covering all related parties engaged in potentially relevant transactions.
- Any documentation specifically required by the transfer pricing regulations.

- A description of the selected pricing method and an explanation of why that method was selected.
- A description of 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 analyse those transactions.
- A description of the comparable uncontrolled transactions or parties that were used with the transfer pricing method, how comparability was evaluated, and what comparability adjustments were made, if any.
- An explanation of the economic analysis and projections relied upon in applying the selected transfer pricing method.

The following additional principal documents must also be maintained by a taxpayer and must be turned over to the IRS within the 30-day period but do not have to exist at the time the relevant tax return is filed:

- A description of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return that would be useful in determining whether the taxpayer's selection and application of its transfer pricing method was reasonable.
- A general index of the principal and background documents related to its transfer pricing analysis and a description of the record keeping system used for cataloguing and accessing these documents.

Background documents

Background documents include anything necessary to support the principal documents, including documents listed in the § 6038A regulations, which cover information that must be maintained by foreign-owned corporations. Background documents do not need to be provided to the IRS in connection with a request for principal documents but if the IRS makes a separate request for background documents, they must be provided within 30 days.

The regulations provide that the 30-day requirement for providing documentation to the IRS applies only to a request issued in connection with an examination of the tax year to which the documentation relates. The IRS has stated that it may also seek to obtain transfer pricing documentation related to subsequent tax years as well. A taxpayer is not required to comply with that request within 30 days in order to avoid potential transfer pricing penalties.

ASC 740-10/FIN 48

Accounting Standards Codification 740-10 (ASC 740-10), formerly referred to as Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), specifies a comprehensive model for how companies should determine and disclose in their financial statements uncertain tax positions that they have taken or expect to take on their tax returns. Existing guidance on the application of income tax law is complicated and at times ambiguous; thus it is often unclear whether a particular position adopted on a tax return will ultimately be sustained or whether additional future payments will be required. As a result of limited specific authoritative literature on accounting for uncertain tax positions, significant diversity in practice has developed. This diversity in accounting raised concerns that tax contingency reserves had become susceptible to earnings manipulations, and that companies' reserves could not reasonably be compared until standards for recording tax benefits were strengthened and standardised.

Under ASC 740-10, a company's financial statements will reflect expected future tax consequences of all uncertain tax positions. ASC 740-10 was effective as of the beginning of fiscal years that start after 15 December 2006. The estimation of tax exposure is to be retrospective as well as prospective. Tax reserves should be assessed under the assumption that taxing authorities have full knowledge of the position and all relevant facts. Each tax position must be evaluated on its own merits, without consideration of offsets or aggregations, and in light of multiple authoritative sources including legislation and intent, regulations, rulings, and case law, as well as past administrative practices and precedents.

Two principles central to ASC 740-10 are recognition and measurement. The principle of 'recognition' means that a tax benefit from an uncertain position may be recognised only if it is 'more likely than not' that the position is sustainable under challenge from a taxing authority based on its technical merits, and without consideration of the likelihood of detection. With regard to 'measurement,' ASC 740-10 instructs that the tax benefit of an uncertain tax position be quantified using a methodology based on 'cumulative probability'. That is, a company is to book the largest amount of tax benefit which has a greater than 50% likelihood of being realised upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

Because transfer pricing is a significant source of tax uncertainty, it must be considered in developing a tax provision. The existence of contemporaneous documentation covering a company's inter-company transactions is not sufficient to eliminate tax exposure uncertainty associated with those transactions. Often, the uncertainty associated with transfer pricing relates not to whether a taxpayer is entitled to a position but, rather, the amount of benefit the taxpayer can claim. The form and detail of documentation required to support a company's determination of its uncertain tax positions associated with transfer pricing will depend on many factors including the nature of the uncertain tax positions, the complexity of the issues under consideration and the materiality of the dollar amounts involved.

Coordination with Schedule UTP

The IRS has finalised Schedule UTP and instructions that certain corporations will use starting with 2010 tax years to report uncertain tax positions as part of their US Federal income tax filings. Additionally, with Announcement 2010-76, IRS is expanding its policy of restraint in connection with its decision to require certain corporations to file Schedule UTP. A directive to LB&I personnel has also been issued setting forth the IRS's planned treatment of these UTPs by examiners and other personnel.

SEC Roadmap: Conversion of US GAAP to IFRS

In November 2008, the US Securities and Exchange Commission (SEC) released its proposed roadmap for the mandatory adoption of International Financial Reporting Standard (IFRS) in the US. The proposed roadmap currently provides that US issuers adopt IFRS for financial reporting purposes as early as 2014, with the potential for voluntary adoption as early as 2009. Although the mandatory conversion date is 1 January 2014, US issuers will be required to issue their financial reports with three-year comparative financials, which means that these companies' financials for 2012 and 2013 must also be reported under IFRS.

For many US-based multinational enterprises the conversion to IFRS presents opportunities to harmonise their internal transfer pricing policies, typically based on US Generally Accepted Accounting Principles (US GAAP), to IFRS, the new accounting standard of choice for many of the jurisdictions in which their affiliates operate. However, considering the significant differences in the accounting for revenue and expense items between US GAAP and IFRS (e.g. as many as four hundred potential differences impacting the pre-tax income), the adoption of IFRS also presents many implementation and risk management challenges that need to be considered well in advance of the conversion date.

The accounting policies adopted by the multinational enterprises' accounting/finance departments will have profound impacts on the multinational enterprises transfer pricing footprint, including the planning and setting of prices, documentation, defence of the group's inter-company policies in the event of an examination by a taxing authority, and in negotiating tax rulings advance pricing agreements, and the like. Considering the significant impacts IFRS conversion will have on the multinational enterprises transfer pricing landscape, it is vital that the tax department be involved, and if not, at the very least, be aware of the implications each of these policies will have on the transfer pricing aspect of the group's tax profile.

Competent authority

The 2006 revenue procedure

The competent authority process may be invoked by taxpayers when they believe that the actions of the US or another country with which the US has concluded a tax treaty, or both parties, result or will result in taxation that is contrary to the provisions of a treaty (i.e. double taxation).

Taxpayers have the option of requesting competent authority assistance without first seeking a review of issues not agreed in the US by the IRS Appeals Division. Issues may also be simultaneously considered by the US Competent Authority and the IRS Appeals Division. Competent authority agreements may be extended to resolve similar issues in subsequent tax years.

Under section 12 of the Revenue Procedure, the limited circumstances in which the US Competent Authority may decline to take up the taxpayer's case with a treaty partner are enumerated. One such circumstance is if the taxpayer does not agree that competent authority negotiations are a government to government activity and they do not include the taxpayer's participation in the negotiation proceedings. Another is if the transaction giving rise to the request for competent authority assistance is a listed transaction under the US regulations as a tax avoidance transaction.

The scope of competent authority assistance

With the exception of the treaty with Bermuda, all US income tax treaties contain a Mutual Agreement Article that requires the competent authorities of the two treaty countries to consult with one another in an attempt to reduce or eliminate double taxation that would otherwise occur when the two countries claim simultaneous jurisdiction to tax the same income of a multinational enterprises or an affiliated group.

The Mutual Agreement Article contained in US tax treaties does not require the competent authorities to reach an agreement eliminating double taxation in a particular case. Rather, the treaties require only that the competent authorities make a good faith effort to reach such an agreement. Thus, there is no guarantee that competent authority assistance will result in the elimination of double taxation in every case; however, in practice the vast majority of cases are concluded with an agreement that avoids double taxation. Latest statistics from the US Competent Authority office (for the IRS's fiscal 2010) indicate that the US Competent Authority completed more cases in its inventory than in any of the five prior fiscal years. The overall processing time for cases has also increased. In fiscal year 2010, the U.S Competent Authority disposed of 271 cases. (This total includes allocation cases (i.e., transfer pricing cases), non-allocation cases (e.g. withholding tax cases), permanent establishment (PE) cases, Limitation on Benefits (LOB) cases (i.e. discretionary relief cases) and Advance Pricing Agreements (APAs)). The fiscal year 2010 ending inventory was slightly down from the prior fiscal year, but the processing time for the closed cases has increased.

Competent authority negotiations are a government-to-government process. Direct taxpayer participation in the negotiations is not permitted. However, a taxpayer may take a very proactive approach to competent authority proceedings, presenting directly to each government its view of the facts, arguments and supporting evidence in a particular case. The taxpayer can facilitate the negotiation process between the two governments by developing alternatives and responses to their problems and concerns.

Competent authority relief is most commonly sought in the context of transfer pricing cases, where one country reallocates income among related entities in a manner inconsistent with the treatment of the same transactions in the other country. In such cases, competent authority relief is intended to avoid double taxation by either eliminating or reducing the adjustment or by making a correlative reduction of taxable income in the country from which income has been allocated. In transfer pricing cases, the US Competent Authority is guided by the § 482 regulations but is not strictly bound by the regulations and may take into account all the facts and circumstances, including the purpose of the treaty to avoid double taxation.

Other types of issues for which competent authority assistance may be sought include, *inter alia*, withholding tax issues, qualifications for treaty benefits and zero rate withholding for dividends and certain treaty interpretative issues.

When to request competent authority assistance
In the case of a US-initiated adjustment, a written request for competent authority relief may be submitted as soon as practical after the amount of the proposed IRS adjustment is communicated in writing to the taxpayer. For a foreign-initiated adjustment, competent authority assistance may be requested as soon as the possibility of double taxation arises. Once competent authority has been requested, the applicable treaty may provide general guidance with respect to the types of issues the competent authorities may address. These issues could be allocation of income, deductions, credits, or allowances between related persons, determination of the source and characterisation of particular items of income, and the common meaning or interpretation of terms used in the treaty.

Pre-filing and post-agreement conferences
The Revenue Procedure provides for a pre-filing conference at which the taxpayer may discuss the practical aspects of obtaining the assistance of the US Competent Authority and the actions necessary to facilitate the negotiations with the foreign treaty partner. The Revenue Procedure also provides for a post-agreement conference after an

agreement has been reached by the competent authorities to discuss the resolution of the issues considered. There is no explicit provision for conferences while the issues are being considered by the competent authorities of both countries but the US Competent Authority has a practice of meeting and/or otherwise communicating with the taxpayer throughout the period of negotiations with the foreign treaty partner.

Small case procedures
To be eligible for the small case procedure, the total proposed adjustments assessments must fall below certain specified amounts. Corporations would qualify for this small case procedure if the proposed adjustments were not more than USD 1 million.

Statute of limitation protective measures
The statute of limitations or other procedural barriers under US or non-US law may preclude or limit the extent of the assistance available from the competent authorities. The US Competent Authority has generally sought to read into treaties a waiver of procedural barriers that may exist under US domestic law, even in the absence of specific language to that effect in the treaty. The same policy is not always followed by the US's treaty partners. Therefore, a taxpayer seeking the assistance of the US Competent Authority must take whatever protective measures are necessary to ensure that implementation of a competent authority agreement will not be barred by administrative, legal, or procedural barriers that exist under domestic law in either country.

In particular, the taxpayer must take steps to prevent the applicable statute of limitations from expiring in the other country. If a treaty partner declines to enter into competent authority negotiations, or if a competent authority agreement cannot be implemented because the non-US statute of limitations has expired, a taxpayer's failure to take protective measures in a timely fashion may cause the US Competent Authority to conclude that the taxpayer failed to exhaust its competent authority remedies for foreign tax credit purposes.

Some US treaties contain provisions that are intended to waive or otherwise remove procedural barriers to the credit or refund of tax pursuant to a competent authority agreement, even though the otherwise applicable statute of limitations has expired. The 2006 Revenue Procedure warns taxpayers not to rely on these provisions because of differences among treaty partners in interpreting these waiver provisions. The limits a treaty may impose on the issues the competent authority may address are also another reason for a taxpayer to take protective measures to ensure that implementation of a competent authority agreement will not be barred.

Most US treaties also contain specific time limitations in which a case may be brought before the applicable competent authorities. These time limitations are separate from the domestic statute limitations. For example, the treaty with Canada requires that the other country be notified of a proposed adjustment within six years from the end of the taxable year to which the case relates. This notification under the treaty can be accomplished, from a US perspective, by filing either a competent authority request pertaining to the proposed adjustments or a letter requesting the preservation of the taxpayer's right to seek competent authority assistance at a later date, after administrative remedies in the other country have been pursued. If the latter course is followed, this letter must be updated annually until such time as the actual competent authority submission is filed or the taxpayer determines it no longer needs to protect its rights to go to competent authority.

Unilateral withdrawal or reduction of US-initiated adjustments
Where the IRS has made a transfer pricing allocation, the primary goal of the US Competent Authority is to obtain a correlative adjustment from the foreign treaty country. Unilateral withdrawal or reduction of US-initiated adjustments, therefore, generally will not be considered. Only in extraordinary circumstances will the US Competent Authority consider unilateral relief to avoid double taxation.

Repatriation of funds following a transfer pricing adjustment
In 1999, the US issued Revenue Procedure 99-32 that provided for the tax-free repatriation of certain amounts following a transfer pricing allocation to a US taxpayer, broadly with the intention of allowing the taxpayer to move funds to reflect the agreed allocation of income following the transfer pricing adjustment. In cases involving a treaty country, coordination with the US Competent Authority is required before concluding a closing agreement with the taxpayer.

The Revenue Procedure requires the taxpayer to establish an account receivable, which may be paid without any tax consequence, provided it is paid within 90 days of the closing agreement or tax return filing for the year in which the adjustment was reported. The following should be taken into account when establishing an account receivable:

- Absent payment of the account receivable within 90 days, the amount is treated as a dividend or capital contribution.
- The account receivable bears interest at an arm's-length rate.
- The receivable is deemed to have been created on the last day of the year subject to the transfer pricing allocation, with the interest accrued being included in the income of the appropriate corporation each year the account receivable is deemed outstanding.

The Revenue Procedure the IRS previously issued in this area provided that previously paid dividends could be offset by the cash payment made in response to the primary transfer pricing adjustment. Under the 1999 Revenue Procedure, a taxpayer may only offset (1) dividends paid in a year in which a taxpayer-initiated adjustment relates if offset treatment is claimed on a timely income tax return (or an amended tax return), or (2) in the same year that a closing agreement is entered into in connection with an IRS-initiated adjustment. In the former case, the dividend is treated as a prepayment of interest and principle on the deemed account receivable.

Under the 1999 Revenue Procedure, relief is not available, however, with respect to transactions where a transfer pricing penalty is sustained. Effectively, this requirement imposes an additional tax for failure to maintain contemporaneous documentation to substantiate arm's-length transfer pricing.

Interest and penalties
The US Competent Authority generally has no authority to negotiate or provide relief with respect to interest and penalties.

Advance pricing agreements (APA)

US procedures
The US was the first country to issue a formal, comprehensive set of procedures relating to the issue of binding advance agreements dealing with the application of

the arm's-length standard to inter-company transfer prices. Under the procedure, the taxpayer proposes a transfer pricing method (TPM) and provides data intended to show that the TPM is the appropriate application of the best method within the meaning of the regulations for determining arm's-length results between the taxpayer and specified affiliates with respect to specified inter-company transactions. The IRS evaluates the APA request by analysing the data submitted and any other relevant information. After discussion, if the taxpayer's proposal is acceptable, a written agreement is signed by the taxpayer and the IRS.

The procedures specify a detailed list of data that must be provided to the IRS with the application. There is also a user fee for participation in the programme, which currently ranges between USD 10,000 and USD 50,000, based on the size of the taxpayer and the nature of the request.

In the application, the taxpayer must propose and describe a set of critical assumptions. A critical assumption is described as any fact (whether or not within the control of the taxpayer) related to the taxpayer, a third party, an industry, or business or economic conditions, the continued existence of which is material to the taxpayer's proposed TPM. Critical assumptions might include, for example, a particular mode of conducting business operations, a particular corporate or business structure, or a range of expected business volume.

The taxpayer must file an annual report for the duration of the agreement, which will normally include:

- The application of the TPM to the actual operations for the year.
- A description of any material lack of conformity with the critical assumptions.
- An analysis of any compensating adjustments to be paid by one entity to another and the manner in which the payments are to be made.

The taxpayer must propose an initial term for the APA appropriate to the industry, product or transaction involved, and must specify for which taxable year the agreement will be effective. The APA request must be filed no later than the extended filing date for the Federal income tax return for the first taxable year to be covered by the APA.

The effect of an APA is to guarantee that the IRS will regard the results of the TPM as satisfying the arm's-length standard if the taxpayer complies with the terms and conditions of the APA. The APA may be retroactively revoked in the case of fraud or malfeasance, cancelled in the event of misrepresentation, mistake/omission of fact, or lack of good faith compliance, or revised if the critical assumptions change. Adherence to the terms and conditions may be subject to audit – this will not include re-evaluation of the TPM.

Traditionally, the IRS APA procedures were limited to issues concerning transfer pricing matters in the context of section 482 of the Internal Revenue Code. However, effective 9 June 2008 the APA procedures (through Rev. Proc. 2008-31) were modified to expand the scope of the APA Programme's purview to include other issues for which transfer pricing principles may be relevant, including: 'attribution of profits to permanent establishment under an income tax treaty, determining the amount of income effectively connected with the conduct by the taxpayer of a trade or business within the US, and determining the amounts of income derived from sources partly within and partly without the US, as well as related subsidiary issues.' The expansion of the programme's scope may not necessarily translate into an immediate increase in the number of non-section 482 cases within the programme as the IRS has publicly indicated that it will be selective in the cases admitted into the programme. Nevertheless, the expansion of the programme's scope of review, providing for other non-section 482 issues that may be resolved through the APA process, is a welcomed development.

Rollbacks
APAs may, at the taxpayer's request at any point prior to the conclusion of an agreement, and with agreement of the responsible IRS District, be rolled back to cover earlier taxable years. This may be an effective mechanism for taxpayers to resolve existing audit issues.

Bilateral and unilateral APAs – impact on competent authority
When a taxpayer and the IRS enter into an APA, the US Competent Authority will, upon a request by the taxpayer, attempt to negotiate a bilateral APA with the competent authority of the treaty country that would be affected by the transfer pricing methodology. The IRS has encouraged taxpayers to seek such bilateral APAs through the US Competent Authority.

If a taxpayer and the IRS enter into a unilateral APA, treaty partners may be notified of the taxpayer's request for the unilateral APA involving transactions with that country. Additionally, the regular competent authority procedures will apply if double taxation subsequently develops as a result of the taxpayer's compliance with the unilateral APA. Importantly, the US Competent Authority may deviate from the terms and conditions of the APA in an attempt to negotiate a settlement with the foreign competent authority. However, the 2006 Revenue Procedure includes a strongly worded warning that a unilateral APA may hinder the ability of the US Competent Authority to reach a mutual agreement, which will provide relief from double taxation, particularly when a contemporaneous bilateral or multilateral APA request would have been both effective and practical to obtain consistent treatment of the APA matters in a treaty country.

APAs for small business taxpayers and IRS-initiated APAs
In an effort to make the APA programme more accessible to all taxpayers, the IRS released a notice in early 1998 proposing special, simplified APA procedures for small business taxpayers (SBT). The notice provides that a SBT is any US taxpayer with total gross income less than USD 200 million. Under the simplified APA procedures, the entire APA process is accelerated and streamlined, and the IRS will provide the SBT with more assistance than it does in a standard APA.

In an effort to streamline the APA process, the IRS may agree to apply streamlined procedures to a particular APA request, even if it does not conform fully to the requirements for 'small business' treatment.

The IRS has announced a programme under which district examiners are encouraged to suggest to taxpayers that they seek APAs, if the examiners believe that APAs might speed issue resolution.

Developments in the APA programme
There is increased specialisation and coordination in the APA office, with teams designated to specific industries/issues, such as automotive, pharmaceutical and medical devices, cost-sharing, financial products and semiconductors.

The APA programme is also getting stricter with its deadlines. From now on, if the date on which the IRS and the taxpayer have agreed to complete an APA passes and the case goes unresolved, both parties will have to submit a joint status report explaining the reason for the delay and mapping out a new plan to close the case within three to six months. If the IRS and the taxpayer fail to meet the second target date, the new procedures call for an automatic all hands meeting of key officials from both sides. For an APA that has been executed, the taxpayer is required to submit an annual report showing its compliance with the terms of the agreement. Taxpayers now must also submit an APA Annual Report Summary, which is a standardised form reflecting key data, as part of the APA annual report.

Compliance assurance process (CAP) programme and transfer pricing

In May 2011, the IRS expanded and made permanent its six-year-old compliance assurance process (CAP) pilot programme for large corporate taxpayers. Under CAP, participating taxpayers work collaboratively with an IRS team to identify and resolve potential tax issues before the tax return is filed each year. With the major potential tax issues largely settled before filing, taxpayers are generally subject to shorter and narrower post-filing examinations. With the CAP programme growing in popularity, it is being expanded to include two additional components. A new pre-CAP programme will provide interested taxpayers with a clear roadmap of the steps required for gaining entry into CAP. A new CAP maintenance programme is intended for taxpayers who have been in CAP, have fewer complex issues, and have established a track record of working cooperatively and transparently with the IRS. The CAP pilot began in 2005 with 17 taxpayers and in FY 2011 there are 140 taxpayers participating. Only taxpayers with assets of USD 10 million or more are eligible to participate. While participation in the CAP programme does not provide taxpayers with the same level of assurance as an agreed APA, it may be a means for large taxpayers to agree on transfer pricing matters ahead of the filing of the return and potentially minimise post-filing transfer pricing examinations.

Comparison with the OECD Transfer Pricing Guidelines

The best method rule

As noted in *The US transfer pricing regulations section, above*, the US regulations require application of the Best Method Rule in the selection of a pricing method. The OECD Guidelines now refer to use of the 'most appropriate method' which in principle is very similar to the 'best method' described in the US regulations. A taxpayer does not necessarily have to examine each method in detail, but must take into account:

- the facts and circumstances of the case
- the evidence available, particularly in relation to the availability of comparable data, and
- the relative reliability of the various methods under consideration, which arguably continues to demonstrate some level of bias towards the use of transactional methods.

Comparability analysis

Both the US regulations and the OECD Guidelines provide that the arm's-length character of an inter-company transaction is ordinarily determined by comparing the results under the regulations or the conditions under the Guidelines (i.e. in both cases meaning either prices or profits) of that controlled transaction to the results realised or conditions present in comparable uncontrolled transactions. Comparability factors that must be taken into account include functions performed, risks assumed, contractual terms and economic conditions present, and the characteristics of the property transferred or the services provided. Determination of the degree of comparability must be based on a functional analysis made to identify the economically significant functions performed, assets used, and risks assumed by the controlled and uncontrolled parties involved in the transactions under review.

Both the US regulations and the OECD Guidelines permit the use of inexact comparables that are similar to the controlled transaction under review. Reasonably accurate adjustments must be made to the uncontrolled comparables, however, to take into account material differences between the controlled and uncontrolled transactions if such adjustments will improve the reliability of the results obtained under the selected pricing method. Both the US regulations and the OECD Guidelines expressly prohibit the use of unadjusted industry average returns to establish an arm's-length result.

An important comparability factor under both the US regulations and the OECD Guidelines is the allocation of risk within the controlled group. The types of risks that must be taken into account under both sets of rules include: market risks; risk of loss associated with the investment in and use of property, plant, and equipment; risks associated with the success or failure of R&D activities; and financial risks such as those caused by currency exchange rate and interest rate variability. In addition, under both sets of rules the determination of which party actually bears a risk depends, in part, on the actual conduct of the parties and the degree to which a party exercises control over the business activities associated with the risk.

Market penetration strategies
Consistent with the US regulations, the OECD Guidelines recognise that market penetration strategies may affect transfer prices. Both the Regulations and the Guidelines require that where a taxpayer has undertaken such business strategies, it must be shown that:

- there is a reasonable expectation that future profits will provide a reasonable return in relation to the costs incurred to implement the strategy, and
- the strategy is pursued for a reasonable period of time given the industry and product in question.

The OECD Guidelines are generally less restrictive concerning market penetration strategies than the US regulations, which require a very extensive factual showing and documentation.

Arm's-length range
Similar to the US regulations, the OECD Guidelines provide that no adjustment should be made to a taxpayer's transfer pricing results if those results are within an arm's-length range. The Guidelines do not include specific rules for establishing the arm's-length range but do recognise that the existence of substantial deviation among the results of the comparables suggests that some of the comparables may not be as reliable as others, or that significant adjustments to the results of the comparables may be necessary.

What has to be at arm's length? Setting prices versus evaluating the result
The primary focus of the US regulations is on whether a taxpayer has reflected arm's-length results on its US income tax return; the actual methods and procedures used by taxpayers to set transfer prices are not relevant. The OECD Guidelines, however, tend to focus less on the results of transfer pricing and more on whether the transfer prices were established in an arm's-length manner substantially similar to the manner in which uncontrolled parties would negotiate prices. Thus, the Guidelines put significant emphasis on factors known by the taxpayer at the time transfer prices were established.

Traditional transactional methods
As noted above the OECD Guidelines express some level of preference for the use of traditional transaction methods for testing the arm's-length character of transfer prices for transfers of tangible property. These methods include the CUP method, the resale price method, and the cost plus method. These same methods are 'specified methods' under the US regulations.

Under both the US regulations and the OECD Guidelines, the focus is on the comparability of products under the CUP method, and the comparability of functions under the resale price and cost plus methods. Under all three methods and under both sets of rules, comparability adjustments must take into account material differences in operating expenses, accounting conventions, geographic markets, and business experience and management efficiency.

There are no material substantive differences between the US regulations and the OECD Guidelines in the theoretical concepts underlying these methods, the manner in which these methods are to be applied, or the conditions under which these methods would likely be the best method.

Other methods
Both the US regulations and the OECD Guidelines provide for the use of other methods when the traditional transaction methods cannot be used. Under the US regulations, a taxpayer may use the CPM or the profit split method. Under the Guidelines, a taxpayer may use the profit split method or the transactional net margin method (TNMM). In most cases, as explained below, the CPM and the TNMM are virtually indistinguishable. The emphasis on comparability throughout the US regulations, however, is intended to limit the use of profit split methods to those unusual cases in which the facts surrounding the taxpayer's transactions make it impossible to identify sufficiently reliable comparables under some other method. The Guidelines, on the other hand, express a strong preference for the use of the profit split over the TNMM.

Transactional net margin method (TNMM)
TNMM compares the operating profit relative to an appropriate base (i.e. a profit level indicator) of the controlled enterprise that is the least complex and owns no valuable intangibles (i.e. the tested party) to a similar measure of operating profit realised by comparable uncontrolled parties in a manner consistent with the manner in which the resale price or cost plus methods are applied. The operating rules for TNMM are thus substantially the same as those for CPM. Both methods require that the analysis be applied to an appropriate business segment and use consistent measures of profitability and consistent accounting conventions.

The OECD Guidelines do require that TNMM be applied on a transactional basis. The precise meaning of this requirement is not clear. It will ordinarily not be possible to identify net profit margins of comparables on a truly transactional basis, and in many cases, taxpayers will have difficulty identifying their own net profits on a transactional basis. In any event, it appears that TNMM is intended to be applied in the same manner as the resale price and cost plus methods, which ordinarily look to overall gross margins for an entire business segment for the full taxable year. Presumably, TNMM should be applied in the same manner.

The OECD Guidelines thus do not prohibit the use of CPM. They do provide, however, that the only profit-based methods such as CPM and so-called modified resale price/cost plus methods that satisfy the arm's-length standard are those that are consistent with TNMM.

Intangible property

In respect to the treatment of intangible property, the OECD issued a chapter discussing the special considerations arising under the arm's-length principle for establishing transfer pricing for transactions involving intangible property which will be revised in the near future. The OECD places emphasis on the actions that would have been taken by unrelated third parties at the time the transaction occurred. The Guidelines focus on the relative economic contribution made by various group members towards the development of the value of the intangible and on the exploitation rights that have been transferred in an inter-company transaction. This is particularly true in the case of the pricing of marketing intangibles. The Guidelines thus focus on economic ownership of the intangible as opposed to legal ownership.

The OECD Guidelines do not provide significant new guidance for the pricing of intangibles by providing specific standards of comparability. The Guidelines, similar to the US regulations provide that prices for intangibles should be based on:

- the anticipated benefits to each party
- prior agreement on price adjustments, or short term contracts, or
- the allocation of the cost or benefit of uncertainty to one party in the transaction, with the possibility of renegotiation in the event of extreme or unforeseen circumstances.

The only pricing method that is specifically approved is the CUP method, which is equivalent to the comparable uncontrolled transaction (CUT) method in the US regulations. The Guidelines give a cautious endorsement to the use of profit split methods or the TNMM when it is difficult to apply a transactional method. This is not inconsistent with the outcome that would be expected if the US Best Method Rule were applied in the same circumstances except for the preference of profit split over the TNMM.

The redefining of the IP ownership rules for non-legally protected intangibles under the proposed regulations will likely attract much debate between the US and its treaty partners who have adopted the OECD Guidelines on this matter. Uncertainties in the definition of 'practical control' and 'economic substance' will be the main drivers of such potential disputes.

Periodic adjustments under the OECD Guidelines

The main area of potential difficulty arises from the focus in the US regulations on achieving an arm's-length result. There is a very evident potential for dispute as to whether the concept of periodic adjustments under the US regulations (*described above*) is at odds with the statements in the Guidelines concerning the use of hindsight. However, the OECD clearly affirms the right of tax authorities to audit the accuracy of the forecasts that were used to establish transfer pricing arrangements, and to make adjustments if the projections on which the pricing was based prove to be inadequate or unreasonable.

Services

Both the US regulations and the OECD Guidelines focus on satisfying the arm's-length standard by the recharge of costs specifically incurred by one group member to provide a service to another group member. Under both the US regulations and the Guidelines, costs incurred include a reasonable allocation of indirect costs.

As to whether the arm's-length charge for services also includes a profit to the service provider, the Guidelines state that the inclusion of a profit margin is normally part of the cost of the services. In an arm's-length transaction, an independent enterprise would normally seek to charge for services in such a way as to generate a profit. There might be circumstances, however, in which an independent enterprise may not realise a profit from the performance of service activities alone. For example, the services provider might offer its services to increase profitability by complementing its range of activities.

The proposed regulations (on Services) are intended to conform the US regulations to the OECD Guidelines by eliminating the cost safe harbour method for non-integral activities. However, this intention is partially negated with proposal of the elective services cost method for certain types of activities deemed 'low margin' services.

Documentation and penalties

The OECD Guidelines recommend that taxpayers make reasonable efforts at the time transfer pricing is established to determine whether their transfer pricing results meet the arm's-length standard, and they advise taxpayers that it would be prudent to document those efforts on a contemporaneous basis. The Guidelines also admonish tax authorities to balance their needs for taxpayer documentation with the cost and administrative burden imposed on taxpayers in the preparation of that documentation. The Guidelines also note that adequate record keeping and voluntary production of documents facilitates examinations and the resolution of transfer pricing issues that arise.

The OECD Guidelines include a cautious acknowledgement that penalties may play a legitimate role in improving tax compliance in the transfer pricing area. The Guidelines encourage member countries to administer any such penalty system in a manner that is fair and not unduly onerous for taxpayers.