9 US transfer pricing rules

INTRODUCTION

901 The importance of the US rules on transfer pricing
This chapter is devoted to a broad outline of US transfer pricing rules and the accompanying penalty regulations. Also covered is the US competent authority procedures, including the Advance Pricing Agreement (APA) programme, and the interaction of the US rules with the OECD Guidelines. The US regulatory environment is of great significance for a number of reasons:

(1) The US is a significant 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 significant issue in international business.

(2) The process of reform of the US transfer pricing regulations in the 1990s, and more recently with changes in the cost sharing, services, and intangible property transfer areas, broke new ground – these developments tended to influence other countries in subsequently increasing the stringency of their own rules. An understanding of developments in the US and the controversies surrounding them are thus a good indicator of likely areas of contention in other countries.

(3) The actions of the US have caused controversy with the country’s 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.

(4) The competent authority process also forms the basis for the APA programme, which has become an increasingly 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, and where there is an adversarial relationship between the government and the taxpayer. This additional compliance burden is not unique to the field of transfer pricing.

902 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 with the result that taxable income in the US may be misstated, and that the lack of documentation on how the pricing was set made it extremely difficult for the IRS to conduct retrospective audits to determine whether the arm’s length standard had been applied in practice.

903 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. (Discussed in 915 to 922.)

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 maintenance of contemporaneous documentation of 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
In 1995, final regulations on cost sharing were issued (which were subject to minor modification in 1996). These regulations are 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. Significant 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.

In 1996, final transfer pricing penalty regulations under § 6662 were issued on 9 February, 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 intra-group services were proposed. The proposed services regulations were replaced by temporary and proposed regulations (Temporary Regulations) issued on 31 July 2006, and these Temporary Regulations are described in this chapter. The commentary in this chapter refers to the final transfer pricing regulations unless otherwise stated. Global dealing regulations were expected to be released in the near future, and the rules 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.

904 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 OCED Guidelines are a significant point of reference for many of the major trading partners of the US in dealing with transfer pricing issues. The extent to which the 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 but at the same time not be exposed to the risk of double taxation and penalties. The substantive provisions of the US Regulations are compared to the OCED Guidelines in this chapter (see Sections 959-970).

905 Transfer pricing audits in the US

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; and these requests to produce supporting documentation within 30 days has become a standard feature of the commencement of such examinations.

THE US TRANSFER PRICING REGULATIONS

906 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 pricing. Under the Best Method Rule, the pricing method selected, under the facts and circumstances of the transactions under review should provide the most reliable measure of an arm’s length result, relative to the reliability of the other potentially applicable methods. The relative reliability of the various transaction based pricing methods depends primarily upon:

1. the use of comparable uncontrolled transactions and the degree of comparability between those transactions and the taxpayer’s transactions under review; and

2. 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 used, and risks assumed 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 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 Section 939).

907 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.

908 Collateral adjustments and set-offs

A taxpayer are 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, the IRS is required to take into account any appropriate collateral adjustment. Should the income of one member of the controlled group be increased under § 482, the other members must recognise a corresponding decrease in income. Taxpayers may also claim set-offs for any non-arm’s length transactions within the controlled group. The regulations limit such set-offs to transactions between the same two taxpayers within the same taxable year. Further, set-offs are strictly applied in accordance with revenue procedures issued by the IRS.

909 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, 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.

910 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.
911 Transfers of intangible property

The implementation of the commensurate with income standard has been a considerable source of controversy with US 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 has been viewed as inconsistent with the way unrelated parties would contract. 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 as part of an examination as to 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 in consistency 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 unrelated 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. The IRS posits that only the commissioner has the right to invoke the commensurate with income standard and not the taxpayer in the 2003 proposed cost sharing regulations.

All prior regulations (including those issued in 1968, 1992 and 1993) 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 who is the primary owner of some categories of intangible assets 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. This is something that all multinational corporations should take into account in planning their 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 that is expected to indicate the 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 section 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 Paper 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 in the future.

912 Provision of intra-group services, use of intangible property and the GlaxoSmithKline case

In July 2006, the Treasury Department and IRS issued temporary and proposed regulations governing the provision of intra-group services. These regulations follow the pattern established for transfers of tangible and intangible property by specifying methods that reference prices and margins earned through transactions with unrelated parties, or by reference to profits earned by parties performing comparable services for unrelated parties. While the 1968 regulations allowed for an intra-group
charge equal to cost for non-integral services, the Temporary Regulations set forth a method that allows a taxpayer to charge cost, without a mark-up, for certain low-margin services specified on a ‘good list’ or for services where comparable transactions between unrelated parties are performed at prices that yield a median mark-up on total costs that is less than or equal to 7%. For more detail regarding the proposed services regulations, please refer to Sections 923-937.

The Temporary Regulations also emphasise the interaction between intra-group services and the use of intangible property. The Temporary Regulations provide numerous examples of situations where a provider of intra-group 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 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 USD3.4 billion. 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 mark-up 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, 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. Multinational corporations marketing similar categories of products in other jurisdictions, including those based in the US, will be wise to follow the progress of the Temporary Regulations towards finalisation and the effects of the Glaxo settlement closely as they may have very wide-ranging implications.
913 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. 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.

914 Profit split methods

Profit split methods are specified methods for testing the arm’s length character of transfers of both tangible and intangible property. The emphasis on comparable transactions throughout the 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 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 suggests the residual profits can be split between parties that provide non-routine contributions (not necessarily intangibles) to the commercial venture.

COST SHARING

915 The US cost sharing regulations

The general principles underlying cost sharing are set out in Chapter 5. The US cost sharing regulations (the 1995 US final cost sharing regulations) were issued in 1995 and became effective on 1 January 1996. New proposed US cost sharing regulations (the 2005 US proposed cost sharing regulations) were issued on 29 August 2005, and, at the time of this writing, are expected to be issued in final form in 2008. The 1995 US final cost sharing regulations replaced prior cost sharing regulations issued in 1968 (the 1968 cost sharing regulations). The 1995 US final cost sharing regulations and 2005 US proposed cost sharing regulations provide detailed rules for the use of cost sharing in the US which:

1. permit unrelated parties to participate in a cost sharing arrangement and exclude all such unrelated parties for purposes of determining whether the arrangement meets the essential requirements of the regulations;
2. define the ‘intangible development area’ that may be covered by a cost sharing arrangement to include all activities related to the development of intangibles
that are actually undertaken pursuant to the terms of the cost sharing arrangement;

(3) permit the determination of a participant's proportionate share of R&D costs to be based on any factor that can reasonably be expected to reflect the participant's proportionate share of anticipated benefits from the use of intangibles developed under the cost sharing arrangement (covered intangibles);

(4) permit the use of projections to estimate anticipated benefits, provided any divergence between projected and actual benefits does not exceed 20%;

(5) require that any IRS adjustments to the allocation of costs under a cost sharing arrangement be made in the tax year in which the costs were incurred;

(6) do not provide safe harbour rules for determining buy-in and buy-out payments but do limit the application of these rules to situations where a covered intangible has been made available to another party; and

(7) provide that a cost sharing arrangement will not be treated as a partnership, and a foreign participant will not be treated as engaged in a US trade or business solely by virtue of its participation in the arrangement.

In addition to describing the 1995 US final cost sharing regulations, the following Sections include significant changes that may occur as a result of the 2005 US proposed cost sharing regulations.

916 A qualified cost sharing arrangement in the US

To constitute a qualified cost sharing arrangement (a CSA), the terms of an arrangement to share R&D costs must be set out in a written document that is contemporaneous with the formation of the arrangement. Under the 1995 US final cost sharing regulations, the essential terms of that written agreement must include:

(1) a list of the participants;

(2) a description of the scope of R&D to be undertaken (the intangible development area);

(3) a description of each participant's interest in any intangibles developed under the arrangement (covered intangibles);

(4) a method for determining each related party participant’s share of intangible development costs based on factors that can reasonably be expected to reflect the participant’s proportionate share of anticipated benefits;

(5) the duration of the arrangement;

(6) the conditions under which the agreement may be modified or terminated; and

(7) provision for adjustments to participants’ cost-shares to reflect material changes in economic conditions and/or business operations.

The 2005 US proposed cost sharing regulations define contemporaneous as recording the written document in its entirety, signed and dated by all participants, no later than 60 days after the first occurrence of any intangible development cost to which the CSA is to apply. In addition, the 2005 US proposed cost sharing regulations require all of the essential terms listed above for the 1995 US final cost sharing regulation
except for (5) and (6). Finally, the 2005 US proposed cost sharing regulations require the following additional essential terms in the written agreement:

1. Specify the functions and risks that each controlled participant will undertake in connection with the CSA;

2. Enumerate all categories of intangible development costs (IDCs) to be shared under the CSA;

3. Specify that the controlled participants must use a consistent method of accounting to determine the IDCs and reasonably anticipated benefit (RAB) shares as described in the 2005 US proposed cost sharing regulations, and must translate foreign currencies on a consistent basis;

4. Require the controlled participants to enter into cost sharing transactions (CSTs) covering all IDCs as described in the 2005 US proposed cost sharing regulations, in connection with the CSA;

5. Require, when applicable, the controlled participants to enter into preliminary or contemporaneous transactions (PCTs) covering all external contributions as described in the 2005 US proposed cost sharing regulations, in connection with the CSA.

A related party that only provides R&D services under contract to one or more of the participants in a cost sharing arrangement without obtaining an interest in the covered intangibles may not be included in that arrangement as a participant. The party providing the contract R&D services must, however, receive from the participants an arm’s length fee for its services, including a profit opportunity. The fees paid by the participants for contract R&D services, including any profit mark-up, must be included in the pool of R&D costs that are shared under the cost sharing arrangement.

Originally, the 1995 US final cost sharing regulations contained a requirement that a qualifying participant must use or reasonably expect to use covered intangibles in the active conduct of a trade or business. This requirement was replaced with a less stringent condition that a participant must reasonably anticipate that it will benefit from the use of a covered intangible. This wording opens, for example, the possibility that a covered intangible may be developed with the intention of licensing it to a third party. There have been suggestions in the past that this aspect of the cost sharing regulations may be reviewed in response to allegations that removal of the active business requirement has led taxpayers to be over-aggressive in their use of tax havens in cost sharing structures. However, the 2005 US proposed cost sharing regulations do not include any changes to the existing definition of a qualifying participant.

917 Cost sharing: the intangible development area and related costs

The 1995 US final cost sharing regulations provide a flexible definition of intangible development costs that encompasses costs that can be allocated to all of the activities that are related to the development of intangibles that are actually undertaken pursuant to the terms of the cost sharing arrangement. Covered intangibles may include intangibles that were not foreseen at the inception of the cost sharing arrangement.

A participant’s costs for R&D include all R&D costs actually incurred by the participant, plus all cost sharing payments it makes to other participants, minus all
cost sharing payments it receives from other participants. Costs include all operating expenses other than depreciation and amortisation (such as advertising, promotion, sales, marketing, warehousing and distribution, and administration expenses) incurred in connection with the intangible development area defined in the cost sharing agreement. Intangible development costs include costs for the use of tangible property (not otherwise included in operating expenses, above) but do not include costs related to the use of tangible property owned by a controlled participant or any intangible property made available to the cost sharing arrangement but do include an arm's length charge for the use of any such property made available to the cost sharing arrangement.

The treatment of compensatory stock options as a cost to be shared has become a controversial issue. The IRS focus on this issue has resulted from the increased use of stock-based compensation by US high-tech companies. In regulations that were finalised in 2003, the IRS provided that the value of compensatory stock options (i.e. the compensation expense portion) is a cost that must be shared among affiliates under a CSA.

The IRS views set forth in the regulations have triggered a wide range of reactions from taxpayers and practitioners. There are concerns that foreign tax authorities may take inconsistent positions, particularly as compensatory stock options are primarily a US phenomenon at this time. The concern as to how the value of stock option compensation is determined, given that there are several different acceptable methods to do so, and the fact that there will likely be a mismatch between the time value of the compensation (and thus the compensation expense deduction) is determined and when the services providers actually performed the services, also has been raised. These concerns no doubt reflect the large amounts at stake: allocation of compensatory stock option costs from the US company to foreign affiliates will increase the amount of the US company's taxable income. The identical issue addressed in the regulations is currently the subject of a number of pending Tax Court cases. In the 2005 US Tax Court case, Xilinx v. Commissioner, 125 T.C. 4 (2005), the court held that the company did not have to include stock option compensation in its expense pool under a qualified CSA. However, at the time of this writing, the IRS is appealing the Tax Court's ruling.

918 Cost sharing: determination of reasonably anticipated benefits

If a CSA is in place, the IRS may not make allocations of income or expenses related to the covered intangibles except to the extent that a participant’s share of R&D costs as determined under the written cost sharing agreement is not proportionate to its share of reasonably anticipated benefits attributable to the covered intangibles. For this purpose, the benefits attributable to the covered intangibles mean the income generated or the costs saved by the participants’ use of the covered intangibles. Moreover, a participant’s reasonably anticipated benefits are the aggregate benefits that the participant reasonably anticipates that it will derive over time from the exploitation of the covered intangibles.

A related party participant’s proportionate share of R&D costs and its share of anticipated benefits are determined by reference only to the allocable costs and anticipated benefits of other related party participants. Costs allocated to unrelated participants and benefits derived by unrelated participants are not considered.
Reasonably anticipated benefits are determined by using the most reliable estimate of the benefits to be derived from the covered intangibles. Anticipated benefits may be measured directly by reference to the estimated additional income to be generated or the costs to be saved. Alternatively, the anticipated benefits may be estimated indirectly by reference to other factors such as units of production, units sold, sales revenue, operating profits, or any other basis of measurement that has a reasonably identifiable relationship to the additional income expected to be generated or costs expected to be saved by the participants’ use of the covered intangibles. The basis for measuring the anticipated benefits must be consistent for all related party participants, and ordinarily must be consistently used over time.

Adjustments may be made, however, to reflect material changes over time in the activities of the participants related to their use of the covered intangibles.

If two or more estimates of the reasonably anticipated benefits are available, in order to determine the most reliable estimate, the completeness and accuracy of the available data and the soundness of the underlying assumptions used in the analysis must be taken into account. If two estimates are equally reliable, either estimate may be used, and no adjustment in the allocation of R&D costs made under the cost sharing agreement should be made by the IRS, based on the difference in the results under the two estimates.

The regulations rely on an application of the Best Method Rule to determine the appropriate method for testing the arm’s length character of inter-company transfers of tangible and intangible property. Accordingly, the regulations allow substantial flexibility but are not definitive regarding the allocation of costs under a cost sharing arrangement.

The regulations provide little guidance on the selection of an appropriate indirect basis for measuring anticipated benefits. The principal requirement is that the basis selected be related to the benefits obtained from using the covered intangibles. Thus, units produced or sold may be a reliable measure of anticipated benefits if each related party participant is expected to have a similar per unit increase in net profit or per unit decrease in net loss attributable to use of the covered intangible. This may be the case, for example, where the participants are engaged in the production and sale of substantially uniform products under similar economic conditions. Similarly, sales revenue may be a reliable measure of anticipated benefits where the costs of exploiting the covered intangibles are not substantial, relative to revenues generated, or the principal effect of using the covered intangible is to increase revenue without increasing costs. Sales revenue is unlikely to be a reliable measure of anticipated benefits unless each participant operates at the same level of market. Operating profit is likely to be a reliable measure of anticipated benefits where such profit is largely attributable to the use of the covered intangible or if the share of profits attributable to the use of the covered intangible is expected to be similar for each participant. This is most likely to be the case where the covered intangibles are integral to the business activity of the participant and the marginal effect on profits of using the covered intangibles is substantially the same for each participant.

Determination of the reasonably anticipated benefits from the covered intangibles necessarily depends upon the reliability of projections. The projections should, generally, include a determination of the time period between the inception of the R&D activity and the realisation of the benefits from that activity. In addition, the projections
include a year-by-year estimate of the benefits to be generated by the use of the covered intangibles. If it is anticipated that the benefits of the participants will not significantly change over time, current annual benefits may be used as a reliable measure of future benefits. Where, however, there will be significant variation among the related party participants in the timing of their receipt of benefits, it may be necessary to use discounted present value calculations to reliably determine a participant’s proportionate share of benefits.

A significant divergence between projected benefit shares and actual benefit shares among the participants in a cost sharing arrangement may indicate that the projections used were not reliable. Projections of benefit shares will not be considered unreliable, based on a divergence of projected and actual benefit shares, provided the divergence for each related party participant is not more than 20% of a participant’s projected benefit share. In addition, projections of benefit shares will not be considered unreliable if the difference between projected and actual benefit shares is due to an extraordinary event beyond the control of the participants.

The 20% rule applies to each participant. Thus, an adjustment of cost-shares may be made by the IRS if any one of the participants fails to meet the 20% test, even though all other participants do meet the exception. Moreover, neither the 20% safe harbour nor the extraordinary event exception will preclude an IRS adjustment if the measure of anticipated benefits was not based on the most reliable measure of anticipated benefits.

For the purpose of determining the divergence between actual and projected benefit shares, all non-US related party participants are aggregated and treated as a single participant. An adjustment by the IRS due to unreliable projections will be made to the cost-shares of foreign participants only if there is a matching adjustment to the cost-shares of US participants, or if the variation between actual and projected benefit shares of the foreign participants has the effect of substantially reducing US income taxes.

The 2005 US proposed cost sharing regulations restate the existing 1995 US final cost sharing regulations with some technical clarifications and changes to conform to the new terminology and framework. The 2005 US proposed cost sharing regulations provide, as is implicit in the existing 1995 US final cost sharing regulations, that for purposes of determining reasonably anticipated benefit shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future, of exploitation of the cost shared intangibles, and must reflect appropriate updates to take into account the most current reliable data regarding past and projected future results as is available at such time.

919 IRS adjustments to a US participant’s cost share

The IRS may not make transfer pricing allocations with respect to a qualifying cost sharing arrangement except to the extent necessary to make each related party participant’s share of intangible development costs equal to its share of reasonably anticipated benefits attributable to the covered intangibles – such adjustments will not ordinarily result in deemed transfers of intangibles. Any such adjustments must be reflected in the year in which the re-allocated costs were incurred. Moreover, when a participant is required to make a cost sharing payment to another participant, the IRS may make appropriate allocations to reflect an arm’s length rate of interest for
the time value of money.

If over time the economic substance of an arrangement becomes inconsistent with the terms of a written cost-sharing agreement, the IRS may impute an agreement that is consistent with the actual conduct of the participants. This could happen, for example, if there is a consistent pattern of one related party participant bearing an inappropriately high or low share of the intangible development costs. This could result in a deemed transfer of an interest in the covered intangibles.

Under the 2005 US proposed cost sharing regulations, taxpayers are prohibited from making periodic adjustments under the commensurate with income standard. Instead, the Commissioner is generally authorised to make allocations to adjust the results of a controlled transaction in connection with a CSA so that the results are consistent with an arm's length result.

As such, the Commissioner may make appropriated adjustments to CSTs to bring intangible development cost shares in line with reasonably anticipated benefit shares. Such adjustments include adding or removing costs from intangible development costs, allocating costs between the intangible development area and other business activities, improving the reliability of the benefits measurement basis used or the projections used to estimate reasonably anticipated benefit shares, and allocating among the controlled participants any unallocated territorial interests in cost-shared intangibles. To the extent the controlled participants consistently and materially fail to bear intangible development costs shares equal to their respective reasonably anticipated benefit shares, the Commissioner is permitted to impute an agreement that is consistent with the controlled participants' course of conduct.

920 Cost sharing: buy-in/buy-out payments

A participant in a cost sharing arrangement acquires an interest in a covered intangible by virtue of having paid for the development of that intangible; no other payment is ordinarily required. A buy-in payment to acquire an interest in an intangible will be required if a pre-existing intangible owned by one participant is made available to the other participants or is otherwise used in the cost sharing arrangement. In that case, each of the other participants must make a buy-in payment to the contributing participant. Similarly, if a new related party participant enters an existing cost sharing arrangement and thereby acquires an interest in covered intangibles, the new participant must make a buy-in payment to each of the related party participants from whom the interest is acquired. Finally, if there is any change in the related party participants' relative interests in covered intangibles, a buy-in payment will be required from all participants obtaining an increased interest in the covered intangibles. A buy-in payment may take the form of a single lump-sum payment, a series of instalment payments, or an ongoing royalty.

A buy-in payment must be equal to the arm's length consideration that would be paid if the transfer of an intangible were to or from an unrelated party. The 1995 US final cost sharing regulations do not provide any safe harbour methods for determining the amount of a buy-in or buy-out payment but rely on the methods set out in the final § 482 regulations dealing with transfers of intangibles. In non-binding rulings involving the valuation of intangibles, the IRS has considered a residual valuation method, which determines intangible asset value by determining the excess of the taxpayer's US stock market capitalisation over the value of the taxpayer's tangible assets,
marketing intangibles, plus other manufacturing intangibles. This method has caused much discussion by taxpayers and practitioners in light of the high US stock market valuations for US internet and other high-tech companies prevalent during the late 1990s. Despite the retreat in the US stock market values for these types of companies, if adopted, this valuation method could result in the significant values for intangible assets, and thus significant buy-in payments.

If a related party participant withdraws from a cost sharing arrangement and by doing so it relinquishes an interest in a covered intangible, a buy-out payment is required only if one or more of the remaining participants obtains an increased interest in the covered intangibles. Thus, the abandonment of specified geographic rights to a covered intangible caused, for example, by the liquidation of a participant previously doing business in that geographic region, may not trigger a buy-out payment unless one of the remaining participants begins doing business in that region.

The 2005 US proposed cost sharing regulations refer to ‘buy-in’ payments as preliminary or contemporaneous transactions (PCTs) and expand the definition of intangible property subject to a PCT payment to potentially include workforce in place, business opportunity and goodwill. Under this new definition, the contribution of an experienced research team in place would require adequate consideration in the buy-in payment. Furthermore, the 2005 US proposed cost sharing regulations expand the rights required to be transferred in order to eliminate a perceived abuse where the transfer of limited rights could result in lower PCT payments. Therefore, under these proposed regulations, the PCT payment must account for the transfer of exclusive, perpetual and territorial rights to the intangible property. Finally, the 2005 US proposed cost sharing regulations do not allow a reduction in the PCT for the transfer of existing ‘make or sell’ rights by any participant that has already paid for these rights.

In addition, the 2005 US proposed cost sharing regulations introduce the ‘investor model’ approach which provides that the amount charged in a PCT must be consistent with the assumption that, as of the date of the PCT, each controlled participants’ aggregate net investment in developing cost shared intangibles pursuant to a CSA, attributable to both external contributions and cost contributions, is reasonably anticipated to earn a rate of return equal to the appropriate discount rate.

In determining the valuation of PCT payments, the 2005 US proposed cost sharing regulations make a modification to the existing residual profit split method, and provide three new methods which include the Income Method, Acquisition Price Method, and Market Capitalisation Method. Under the proposed regulations the residual profit split method may not be applied where only one participant makes significant non-routine contributions to the development and exploitation of cost shared intangibles of a CSA.

On 27 September 2007, the IRS reaffirmed its positions in the 2005 US proposed cost sharing regulations with the issuance of the Coordinate Issue Paper (LMSB-04-0907-62) addressing buy-in payments (or PCTs) associated with cost sharing arrangements in all industries. The Paper’s purpose is to coordinate, in the field, the examination of all CSAs.

921 Cost sharing: administrative requirements
A related party participant must maintain documentation necessary to establish the total amount of intangible development costs incurred under the cost sharing
arrangement and how each participant’s share of those costs was determined. The 2005 US proposed cost sharing regulations require controlled participants to a CSA to timely update and maintain documentation sufficient to meet 10 separate requirements specified in the proposed regulations. This documentation must be provided to the IRS within 30 days of a request. In addition, in order to satisfy the documentation requirements, each controlled participant must file a ‘Statement of Controlled Participant to Section 1.482-7 Cost Sharing Arrangement’ that complies with the requirements in the 2005 US proposed cost sharing regulations with the IRS Ogden campus within 90 days after the first occurrence of an intangible development cost to which the newly formed CSA applies. Thereafter, for the duration of the CSA, each controlled participant must attach a copy of the original CSA statement along with a schedule of changes to its US income tax return, Schedule M of any Form 5471, any Form 5472 or any Form 8865 filed with respect to that participant.

922 Proposed cost sharing regulations in summary
Sections 915-921 include discussions of the CSA rules under the existing regulations as well as potential significant proposed changes as a result of the 2005 US proposed cost sharing regulations. At the time of writing, it is anticipated that the 2005 US proposed cost sharing regulations will be finalised by the end of 2008. These proposed regulations reflect the concern on the part of the IRS and Treasury that the current regulations allow excessive flexibility in CSAs, and have facilitated what the government considers insufficient buy-in amounts paid to US entities that have contributed pre-existing intangible assets to CSAs.

In summary, the 2005 US proposed cost sharing regulations include three new specified methods of valuation for determining the arm’s length buy-in amount and subsequently evaluating it under a new interpretation of the commensurate with income standard, which would permit the IRS but not taxpayers, to adjust buy-in amounts. If adopted in its current form, future CSAs would have to provide in all cases for division of cost-share benefits according to non-overlapping geographic territories. Buy-ins would be measured against an investor model, with emphasis on the realistic alternatives principle available to the parties in the CSA. Buy-in payments would be required to be made for all external contributions to the cost-shared activity. This would include contributions of pre-existing or acquired intangibles, including (controversially) contributions in the form of available workforce in place, anticipated contribution of services and other similar items. The buy-in calculation, however, would not cover the transfer of rights to manufacture or sell current products, which must be valued separately under the existing transfer pricing rules relating to transfers of intangible property.

It is likely that many existing CSAs would need to be amended to conform to the new rules, and buy-in payments made under existing CSAs after the effective date would have to conform to the new ‘realistic alternatives’ principle.

The implications of the 2005 US proposed cost sharing regulations are still being evaluated but if enacted without amendment to some of their more controversial aspects, the US regime for cost sharing would become far more restrictive.
SERVICES REGULATIONS

923 The US services regulations
The existing US services regulations were issued in 1968, which included the cost safe harbour rule and priced services 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. These regulations are effective for taxable years beginning after 31 December 2006. Taxpayers may elect to apply these regulations retroactively to taxable years beginning after 10 September 2003 if all Temporary Regulations are applied to all of the taxpayer’s taxable years.

924 Services cost method
The 2006 regulations introduced a new pricing method, the Services Cost Method (SCM) which replaced the previously proposed SCBM. On 16 January 2007, the IRS issued Notice 2007-5, extending the effective date for use of the SCM one year, applying to taxable years beginning 1 January 2008. 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.

Also, in the 16 January 2007 notice, the IRS issued Rev. Proc 2007-13, which expanded the ‘good list’ to over 100 low-margin services eligible for the SCM that can be priced at cost, without a mark-up. A service that is not identified on the good list can qualify for the SCM if a benchmarking analysis is performed and the median mark-up on total costs yielded from a set of comparable service providers is less than 7% (low margin services). However, the SCM method is elective, and taxpayers have the option to charge mark-ups for services identified on the good list.

In addition to the good list and the low-margin services, a taxpayer must also comply with the Business Judgment Rule, which is effective for taxable years beginning after 31 December 2006. 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. Therefore, during the transition period (1 January 2007 – 31 December 2007) taxpayers may continue to apply the cost safe harbour (i.e. integral vs. non-integral approach) in conjunction with the business judgment rule, but should be including stock-based compensation in total costs.

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

- Manufacturing;
- Production;
US transfer pricing rules

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

925 Profit split method

The Profit Split Method (PSM) is modified under the new Temporary Regulations requiring the split of residual profits to be based on ‘non-routine contributions’ rather than on contributions of intangibles. The IRS defines non-routine contributions as ‘one for which the returns cannot be determined by reference to benchmarks.’ The new regulations attempt to clarify the application of the PSM for high-value services under Treas. Reg. 1.482-9T(g)(1) which now states that the PSM is ‘ordinarily used in controlled services transactions involving a combination of non-routine contributions by multiple controlled taxpayers.’ The Temporary Regulations have eliminated references to ‘high value’ and ‘highly integrated transactions,’ however, ‘routine’ transactions are not indicative of transactions with low value. Non-routine contributions include services that cannot be determined by reference to market benchmarks, (e.g. government contracts, reputation, track record of success in a territory of business).

926 Contractual arrangements and embedded intangibles

In analysing transactions involving intangible property, the Temporary 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. The economic substance must be in accord with the arm’s length standard.

927 Ownership of intangibles

The Temporary 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 Temporary Regulations eliminate the possibility of multiple ownership of a single intangible, as is the case under the ‘developer-assister’ rule in the existing regulations.

928 Benefit test

The conditions in which an activity is deemed to provide the recipient with a benefit have been revised in the Temporary Regulations. The conditions are:

1. If the activity directly results in a reasonably identifiable value that enhances the recipient’s commercial position, or that may reasonably be anticipated to do so; or
(2) If an uncontrolled taxpayer in comparable circumstances would be willing to pay an uncontrolled party for the same or similar activities, or the recipient otherwise would have performed the same or similar activity for itself.

In regards to Passive Association, the Temporary Regulations state that if a benefit results from the controlled taxpayer's status as a member of a controlled group, the recipient is deemed not to obtain a benefit.

Duplicative activities occur 'if an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.' The Temporary Regulations state that duplicative activities result in a benefit if they also reduce the commercial risk associated with the transaction.

929 Pass-through costs
The Temporary Regulations further clarify the rules for 'pass-through' of external costs without a mark-up. 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 mark-up under the transfer pricing method used to analyze the controlled services transaction, the Temporary Regulations allows for the evaluation of the third party costs (if material) to be evaluated on a disaggregated basis from the covered service transaction.

930 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.

931 Stewardship and shareholder activities
The Temporary Regulations shifts the focus in defining benefit from the service provider to the recipient to be consistent with OECD Guidelines.

Shareholder activities are defined under the Temporary Regulations as an activity in which the 'sole effect,' rather than the 'primary effect' of that activity is either to protect the renderer's capital investment in the recipient or in the other members of the controlled group or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. No charge would be assessed to the group member(s) for these shareholder activities. Examples:

(1) Preparation and filing of public financial statements; and

(2) Internal Audit activities.

Stewardship activities are defined 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:
(1) 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;

(2) Under the Temporary Regulations, the IRS may require US multinationals to charge for many centralised group services provided to foreign affiliates; and

(3) 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.

932 Stock-based compensation

The IRS has clarified that stock-based compensation must be included in the total services cost pool. In a comparable analysis, the Temporary Regulations indicate that it is appropriate to adjust the comparables’ financial data when there is a ‘material difference in accounting for stock-based compensation,’ and this difference would affect the arm’s length result, adjustments to improve comparability should be made. These adjustments may have an affect on the total services cost of the tested party, the comparables, or both. Examples how total services costs and operating income of the tested party and comparables should be adjusted to account for stock-based compensation are provided in the Temporary Regulations.

The Temporary Regulations do not indicate a best method for calculating stock-based compensation between grant date and spread-at-exercise. However, the examples provided in the Temporary Regulations lean towards a preference for grant date valuation.

933 Shared services arrangements

The Temporary 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 mark-up. 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.

934 Financial guarantees

Financial guarantees are excluded as eligible services for application of the SCM because the provision of financial guarantees requires compensation at arm’s length under the Temporary Regulations. The Temporary Regulations reserve this matter to be addressed in the new ‘Global Dealings’ regulations, which at the writing of this chapter have yet to be released.

935 Contractual relationships

The Temporary Regulations attempt to clarify when the IRS may impute contractual relationships based on economic substance. Examples in the Temporary Regulations illustrate how economic substance of contractual terms between related parties would be honoured even if the cost plus remuneration percentage was determined by the IRS to fall outside of the arm’s length range. However, in the event that the cost plus
determined by the taxpayer is substantially outside the arm’s length range, the IRS may impute the contractual relationships. It is unclear what the IRS constitutes as a significant deviation outside the arm’s length range.

936 Contingent payments
The Temporary Regulations eliminate having to consider whether an uncontrolled taxpayer would have paid a contingent fee if it engaged in a similar transaction under comparable circumstances. Instead, emphasis is placed on the importance of the economic substance principles under the existing regulations. In other words, whether a particular arrangement entered into by controlled parties has economic substance is not determined by reference to whether it corresponds to arrangements adopted by uncontrolled parties.

937 Documentation requirements
The Temporary 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.

During this transition period, the IRS is providing taxpayers with penalty relief by not penalising taxpayers that undertake reasonable efforts to comply with the new regulations.

THE US PENALTY REGIME

938 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’.

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.

The regulations also impose a 20% net adjustment penalty on a tax underpayment attributable to a net increase in taxable income caused by a net transfer pricing adjustment that exceeds the lesser of USD5 million or 10% of gross receipts. The penalty is increased to 40% if the net transfer pricing adjustment exceeds USD20 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.

For both the transactional penalty and the net adjustment 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, regardless of 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.

939 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; and

(7) the size of a transfer pricing adjustment in relation to the magnitude of the intercompany 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.

940 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 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).

941 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:

(1) an overview of the taxpayer’s business, including an analysis of economic and legal factors that affect transfer pricing;
(2) a description of the taxpayer’s organisational structure, including an organisational chart, covering all related parties engaged in potentially relevant transactions;

(3) any documentation specifically required by the transfer pricing regulations;

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

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

(6) a description of the controlled transactions, including the terms of sale, and any internal data used to analyse those transactions;

(7) 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; and

(8) 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:

(1) 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; and

(2) 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.

942 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.

943 FIN 48

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 FIN 48, a company’s financial statements will reflect expected future tax consequences of all uncertain tax positions. FIN 48 is 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 FIN 48 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,’ FIN 48 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.

944 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 there financial reports with three-year comparative financials, which means that these companies’ financials for the 2012 and 2013 must also be reported under IFRS.
For many US MNCs, the conversion to IFRS presents opportunities for these companies 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 MNCs accounting/finance departments will have profound impacts on the MNCs 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 MNCs 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**

945 The 2006 revenue procedure

The competent authority process may be invoked by taxpayers when they consider 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.

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.

946 The scope of competent authority assistance

With one exception, 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; in practice, however, the vast majority of cases are concluded with an agreement that avoids double taxation. Latest statistics from the US CA (for the IRS’s fiscal 2007) office indicates that it was able to obtain relief (full or partial) approximately 96% of the cases reviewed.

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.

947 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.

948 Competent authority: 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.

949 Competent authority: 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 USD1 million.

950 Competent authority: 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.

951 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.

952 Competent authority: 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, co-ordination 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:

(1) Absent payment of the account receivable within 90 days, the amount is treated as a dividend or capital contribution.

(2) The account receivable bears interest at an arm’s length rate.

(3) 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 (i) 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 (ii) 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.
US transfer pricing rules

953 Interest and penalties
The US competent authority generally has no authority to negotiate or provide relief in respect of interest and penalties.

ADVANCE PRICING AGREEMENTS (APAS)

954 APAs: 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 analyzing 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 program, which currently ranges between USD10,000 and USD50,000, 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:

1. the application of the TPM to the actual operations for the year;
2. a description of any material lack of conformity with the critical assumptions; and
3. 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. 208-31) were modified to expand the scope of the APA Program’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 United States, and determining the amounts of income derived from sources partly within and partly without the United States, as well as related subsidiary issues.’ The expansion of the program’s scope may not necessarily translate into an immediate increase in the number of non-section 482 cases within the program as the IRS has publicly indicated that it will be selective in the cases admitted into the program. Nevertheless, the expansion of the program’s scope of review, providing for other non-section 482 issues that may be resolved through the APA process, is a welcomed development.

955 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.

956 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.

957 APAs for small business taxpayers and IRS-initiated APAs

In an effort to make the APA program 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 USD200 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 program under which district examiners are encouraged to suggest to taxpayers that they seek APAs, if the examiners believe that APAs might speed issue resolution.

958 Developments in the APA program

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 program 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.

COMPARISON WITH THE OECD TRANSFER PRICING GUIDELINES

959 The best method rule

As noted in 906, the US Regulations require application of the Best Method Rule in the selection of a pricing method. The OECD Guidelines do not explicitly refer to the Best Method Rule by name but do adopt the same principle. Under the OECD Guidelines, a taxpayer must select the method that provides the best estimate of an arm’s length price, taking into account:

(1) the facts and circumstances of the case;

(2) the mix of evidence available; and

(3) the relative reliability of the various methods under consideration.

960 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.

961 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:

(1) there is a reasonable expectation that future profits will provide a reasonable return in relation to the costs incurred to implement the strategy; and

(2) 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.

962 Arm’s length range
Like 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.

963 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.

964 Traditional transactional methods

The OECD Guidelines express a strong 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. The US Regulations and the Guidelines differ only in their evaluation of the probability that comparable uncontrolled transactions can be identified, and that adequate and reliable data about the comparables can reasonably be obtained. While the Guidelines recognise that there may be practical problems in the application of these methods in some cases, the Guidelines assume that such cases will be the exception.

The OECD Guidelines provide as follows:

Traditional transaction methods are the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm’s length. As a result, traditional transaction methods are preferable to other methods. However the complexities of real life business situations may put practical difficulties in the way of the application of the traditional transaction methods. In those exceptional situations, where there are no data available or the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods, it may become necessary to address whether and under what conditions other methods may be used.

The experience in the US has been that it often is not possible to identify uncontrolled transactions that meet the comparability standards for the traditional transaction methods, which are substantially the same under both the US Regulations and the OECD Guidelines. Thus, the inability to apply these methods in practice is likely to be a common case, and not the exceptional case as is assumed by the Guidelines.
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 has recently issued a chapter discussing the special considerations arising under the arm’s length principle for establishing transfer pricing for transactions involving intangible property. 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:

1. the anticipated benefits to each party;
2. prior agreement on price adjustments, or short term contracts; or
3. 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.

968 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.

969 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 (See 923 to 937).

970 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.
Transfer pricing considerations affect every company, large or small, with international affiliates, offering planning opportunities whilst imposing increasingly burdensome compliance obligations. As governments throughout the world implement stringent transfer pricing regulations, those multinationals without a robust, consistent and defensible policy will be exposed to financial penalties exacted by fiscal authorities.

International Transfer Pricing 2009, now in its eleventh edition, provides companies and their advisors with practical guidance on how to approach the issue of determining defensible transfer pricing across the full range of goods and services, as well as how to prepare for the negotiations in which they must be sustained. This edition has been updated to include fully revised overviews of the position in sixty countries, seeking to provide clear and comprehensive coverage of this complex subject.

The book has been written in the light of extensive knowledge and experience gathered by the global transfer pricing network of PricewaterhouseCoopers. The principal author and editor of the 2009 edition is Nick Raby, transfer pricing principal and leader of the PricewaterhouseCoopers practice in the Western United States.

www.pwc.com/internationaltp

PricewaterhouseCoopers provides industry-focused assurance, tax, and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 155,000 people in 153 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

© 2009 PricewaterhouseCoopers LLP. All rights reserved. ‘PricewaterhouseCoopers’ refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

Design Services 23563 (04/09).