

A PRIMER ON TRANSFER PRICING

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A FORMER ATTORNEY WITH THE IRS CHIEF COUNSEL (INTERNATIONAL), ROBERT MISEY, PROVIDES AN INTRODUCTION TO THE FUNDAMENTAL CONCEPTS INVOLVED IN DETERMINING THE PRICE CHARGED FOR INTERCOMPANY TRANSACTIONS.

A transfer price is the price charged for intercompany transactions. The principles of Code Sec. 482 require that intercompany transactions be priced at arm's length. Although ostensibly a simple concept, the arm's length standard has spawned hundreds of pages of regulations and case law.

Transfer pricing continues to be a hot issue for multinational companies. I have learned informally from former IRS colleagues that companies with sales in excess of \$15 million can expect to have an IRS economist review their intercompany transactions. Because intercompany transactions across international borders continue to expand and because the IRS continues to rigorously review intercompany transactions, transfer pricing is more than just the tax issues of the 1990s, it is the tax issue for the next millennium.

Despite the political awareness the current administration created over the amount of taxes paid by Japanese-owned companies, many U.S.-based companies do not worry about transfer pricing. However, the transfer pricing regulations can

trap U.S.-owned companies with modest operations abroad just as easily as foreign-owned companies.

For example, suppose WisCo manufactures and sells widgets in the United States. Due to increased widget orders from Canadian customers, WisCo decides to form a Canadian distribution subsidiary ("CanSub"). Although CanSub does not have any manufacturing functions, CanSub employs its own administrative and sales staff while using WisCo's unique distribution software to ensure that there are not any distribution problems. In an effort to make sure that CanSub is financially solvent, CanSub has payment terms to WisCo of six months and, if CanSub's customers do not pay, CanSub enjoys the use of WisCo's collection staff, which is comprised of former defensive linemen for the University of Wisconsin. CanSub's average collection period is two months.

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The remainder of this article will review how the U.S. transfer pricing regulations should affect the intercompany transactions between WisCo and CanSub.

THE BEST METHOD RULE

The best method rule in the Code Sec. 482 regulations requires that the arm's length result of a controlled transaction be determined under the method that, given the facts and circumstances, provides the most reliable measure of an arm's length result. Application of

company transaction tax professionals traditionally contemplated when reviewing transfer pricing. The arm's length amount charged in intercompany transactions involving tangible property should be tested under one of the following methods: the comparable uncontrolled price method; the resale price method; the cost plus method; the profit split method; and the comparable profits method.³

The comparable uncontrolled price ("CUP") method compares amounts charged in intercompany

transactions with amounts charged in comparable third-party transactions.⁴ If WisCo can find a comparable sale of its product to a third party, WisCo may

try to apply the CUP method. For example, WisCo may try to compare sales to a major customer with sales to CanSub. However, the stringent comparability requirements regarding sales volume, geographic markets, currency exchange and others may make the sales to the major customer uncomparable.

The resale price method ("RPM") evaluates whether the amount charged in an intercompany transaction is at arm's length by reference to the gross margin a comparable reseller would realize.⁵ For example, if CanSub can find comparable distributors of widgets in Canada, it may try to apply the RPM. However, the presence of different functions performed and risks assumed by the comparable distributors (*i.e.*, a marketing function or sales function), and the difficulty in obtaining the gross

margin of these comparable distributors may affect the applicability of this method.

The cost plus method compares the gross margins on intercompany sales with gross margins on third party sales.⁶ For example, if WisCo receives a five-percent mark-up on its sales to CanSub and a five-percent mark-up on sales to third parties, WisCo's sales should be at arm's length. However, as with the CUP method, the intercompany and third-party sales may face a host of comparability problems.

The profit split methods allocate operating profits from intercompany transactions in proportion to the relative contributions of each party in creating the combined profits.⁷ WisCo should review the functions performed, risks assumed, resources employed and costs incurred to determine relative contributions. There are two types of profit split methods: (1) the comparable profit split method; and (2) the residual profit split method. Although the Japanese taxing authorities favor profit splits, profit splits are hard for the tax professional to apply because they involve the extremely difficult task of finding two unrelated companies that have functions, risks and transactions comparable to WisCo and CanSub.

The comparable profits method ("CPM") compares the profitability of the less complex party ("CanSub") to that of comparable companies.⁸ As with profit splits, the CPM is based on profits rather than individual transactions. In applying the CPM, the tax professional and the economist will choose a financial ratio for CanSub and determine if CanSub's ratio is in the interquartile range for all comparable distributors.

APPLICATION OF THE BEST METHOD RULE ESTABLISHES AN ARM'S LENGTH RANGE OF PRICES OR FINANCIAL RETURNS WITH WHICH TO TEST CONTROLLED TRANSACTIONS.

the best method rule establishes an arm's length range of prices or financial returns with which to test controlled transactions. The tested party must fall within the middle 50 percent of that range, known as the interquartile range.¹

In determining the best method, WisCo should consider the degree of comparability between controlled and uncontrolled transactions by analyzing the functions, contractual terms, risks, economic conditions, and the nature of goods and services supplied. If this analysis requires numerous or sizable adjustments to meet comparability, the unreliability of the comparable may result in its exclusion.²

TANGIBLE PROPERTY

The sale of widgets from WisCo to CanSub constitutes a sale of tangible property, which is the type of inter-

Two factors make the CPM easy to use: (1) comparability is based on functions performed and risks assumed, as opposed to comparability of product; and (2) financial information is easily derived from information that public companies disclose. Finally, although other countries have not shown enthusiasm for the CPM, the CPM is arguably similar to Canada's Transaction Net Margin Method and is clearly the method of choice for the IRS's International Examiners.

INTANGIBLE PROPERTY

The transfer pricing regulations broadly define intangible property to include:⁹

- patents, inventions, formulae, processes, designs, patterns, or know-how;
- copyrights and literary, musical, or artistic compositions;
- trademarks, trade names, or brand names;
- franchises, licenses, or contracts;
- methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- other similar items.

CanSub's use of WisCo's unique distribution software, regardless of whether the software is patented, constitutes a method, program or system and is the transfer of an intangible. Transfers of unique intangibles gave the IRS fits in the 1980s and led to the new transfer pricing regulations.¹⁰ In determining the arm's length price for the transfer of an intangible, WisCo has a choice of three methods: the comparable uncontrolled transaction ("CUT") method; the profit split methods; and the CPM.¹¹

The comparable uncontrolled transaction method ("CUT") method is the intangible analog to

the CUP method.¹² As a result, it is subject to the same stringent comparability requirements as the CUP method. Although companies do not usually license the use of unique intangibles, WisCo may apply this method if WisCo licenses the distribution software in transactions that meet those stringent comparability requirements.

The profit split methods and the CPM are applied in the same manner as they are for tangible property. As a result, the profit split methods are similarly difficult to apply while the CPM should be more practical.

LOANS

Although many rules deal with the proper amount of interest charged between related parties, the transfer pricing regulations have their own twist that applies after the taxpayer has applied the other sections.¹³ In our hypothetical, WisCo has a trade receivable from CanSub for six months. The transfer pricing loan regulations generally apply to bona fide indebtedness beginning on the date after the indebtedness occurs, with several exceptions.¹⁴ These exceptions include:

- two months of relief for transactions in the ordinary course of business;
- three months of relief for a debtor outside the United States;
- an unspecified time of relief for the regular trade practice of the creditor's industry; and
- relief for property purchased for resale in a foreign country to the extent of the related

purchaser's average collection period plus 10 days.

Assuming that WisCo cannot show that it is the custom of the widget industry to provide six-month payment terms, WisCo should receive imputed interest for the three months beyond the three months of relief for a debtor (CanSub) located outside the United States.¹⁵

The arm's length rate of interest imputed must be between 100 to 130 percent of the applicable federal rate.¹⁶ Because the payment terms of six months are less than three years, WisCo should apply the Federal short-term rate. Terms between three and nine years require the Federal mid-term rate and terms over nine years require the Federal long-term rate.

SERVICES

A member of a controlled group must receive an arm's length charge

IN THE APA PROGRAM, THE TAXPAYER AND THE IRS PROSPECTIVELY AGREE TO THE TAXPAYER'S FACTS, TRANSFER PRICING METHODOLOGY AND AN ARM'S LENGTH RANGE OF RESULTS.

for performing marketing, managerial, administrative, technical or other services for the benefit of another member of the group. In our hypothetical, WisCo provides collection services to CanSub and should receive an arm's length charge for those services.

The arm's length charge for the performance of services is generally the cost incurred regarding the services.¹⁷ These costs are both direct and indirect costs. Direct costs constitute the compensation paid

and travel expenses of employees performing the services, material supplies consumed, telecommunications expenses and similar items. Indirect costs constitute an allocation of a broad range of overhead expenses.

If the services are an integral part of the business activity of either the renderer or recipient of the services, the renderer should charge a mark-up.¹⁸ Whether the services are integral is a facts and circumstances test. WisCo should apply the safe harbor stating that services are not integral if WisCo's costs of providing the services constitute less than 25 percent of WisCo's total costs and less than 25 percent of CanSub's total costs (excluding both of their costs of goods sold).

Because the transfer pricing regulations for services do not specify a method for determining an arm's length mark-up, presumably any method meeting the reliability and comparability requirements of the best method rule should be sufficient.

PENALTIES

If the IRS determines that (1) an intercompany transfer price was less than 50 percent or more than 200 percent of an arm's length price or (2) the transfer pricing adjustment increases taxable income by \$5 million or more, WisCo must pay a penalty equal to 20 percent of the additional tax. The penalty in-

creases to 40 percent if (1) the intercompany transfer price was less than 25 percent or more than 200 percent of an arm's length price or (2) the transfer pricing adjustment is \$20 million or more.¹⁹

WisCo can protect itself against a penalty through either documenting²⁰ its transfer pricing practices or entering into an advance pricing agreement ("APA").²¹

The documentation must state the reasons for believing the prices are at arm's length, and must be in place when the return is filed, but does not have to be provided to the IRS until requested on audit. More specifically, the documentation must provide a business description, a thorough analysis of the intercompany transactions, a detailed functional analysis of the relevant parties, a review of the transfer pricing methods resulting in the method chosen and an economic analysis showing the arm's length nature of the transfer pricing. It is the author's experience that transfer pricing documentation not only protects the taxpayer from a penalty, but often persuades the IRS that a transfer pricing adjustment is not necessary. As a result, even if WisCo previously failed to contemporaneously document its transfer pricing for an open year, WisCo should consider preparing documentation if it expects an examination of that year.

In the APA program, the taxpayer and the IRS prospectively agree to the taxpayer's facts, transfer pricing methodology and an arm's length range of results. The APA will include a set of critical assumptions that, if followed, will not result in an examination of transfer pricing in the future. WisCo may be hesitant to voluntarily provide the necessary information to the IRS to obtain an APA, but likely will have to provide this information anyway if WisCo is a large enough taxpayer to be a target of the IRS' Coordinated Examination Program. Although APAs traditionally have been within the purview of only large companies, the IRS recently issued streamlined procedures to make the process more cost efficient for smaller companies.²²

CONCLUSION

The simplest scenarios for expanding a business abroad may bring transfer pricing problems to a Tax Director. Although the transfer of tangible property is the most obvious, transfers of intangible property, loans in the form of extended payment terms, and the provision of services may also cause problems. Fortunately, several planning tools, such as documentation and APAs, can prevent unexpected surprises while avoiding adjustments and penalties.

ENDNOTES

¹ Reg. §1.482-1(b) through Reg. §1.482-1(f).
² *Id.*
³ Reg. §1.482-3(a).
⁴ Reg. §1.482-3(b).
⁵ Reg. §1.482-3(c).
⁶ Reg. §1.482-3(d).
⁷ Reg. §1.482-6.
⁸ Reg. §1.482-5.
⁹ Reg. §1.482-4(b).

¹⁰ *A Study of Intercompany Pricing under Section 482 of the Code*, Notice 88-123, 1988-2 CB 458.
¹¹ Reg. §1.482-4(a).
¹² Reg. §1.482-4(c).
¹³ Reg. §1.482-2(a)(3).
¹⁴ Reg. §1.482-2(a)(1)(iii).
¹⁵ It is also possible that Canada may impute a withholding tax of 10 percent on the imputed interest.

¹⁶ Reg. §1.482-2(a)(2).
¹⁷ Reg. §1.482-2(b).
¹⁸ Reg. §1.482-2(b)(7).
¹⁹ Reg. §1.6662-6(b) and Reg. §1.6662-6(c).
²⁰ Reg. §1.6662-6(d)(2)(iii).
²¹ Rev. Proc. 96-53, 1996-2 CB 375.
²² Notice 98-10, IRB, 1998-6, 9.