Transfer Pricing Associates

UNITED STATES

LEGISLATION	
Existence of Transfer Pricing Laws / Guidelines	Under Section 482 of the Internal Revenue Code (IRC) of the U.S. Treasury, the Internal Revenue Service has the authority to adjust the allocation of gross income, deductions, credits or allowances among or between businesses that are owned or controlled directly or indirectly by the same interests if such adjustments are necessary to prevent the evasion of tax or clearly to reflect the income of such businesses. The corresponding Section 1.482 of the U.S. Treasury Regulations (Section 1.482) sets forth the general principles and guidelines to be followed under Section 482 of the IRC, and establishes the arm's length principle as the standard for determining the true taxable income of a taxpayer. The Section 1.482 Regulations were largely finalized in 1994, but in recent years they have been augmented in several fundamental ways. On August 25, 2003, the IRS and the Treasury Department issued final regulations on the treatment of stock- based compensation for purposes of the rules governing qualified cost sharing arrangements ("CSAs") and for purposes of the comparability factors to be considered under the comparable profits method under Regulations 1.482 -5. The final regulations are effective August 26, 2003 and apply to stock- based compensation granted in tax years beginning on or after such date. In August 2006, the U.S. Treasury released new temporary service regulations (§1.482 -9T). The prior service regulations had been in place since 1968, and did not present any specified methods for determining an arm's length charge in connection to a service; the temporary regulations specify several methods that parallel those employed in analyzing inter-company sales of inventory (tangible goods). The temporary service regulations went into effect for taxable years commencing after December 31, 2006. Concurrently, the U.S. Treasury also altered portions of §1.482 -4, which deals with controlled transfers of intangible property. These changes were meant to provide greater guidance under circumstances in which a controlled party makes contributions to an intangible owned by another party. In addition to issuing new regulations, the IRS and the U.S. Treasury have also proposed new regulation s pertaining to global dealings and cost-sharing arrangements, both of which have yet to be finalized. The proposed global dealings regulations pertain mostly to the financial sector, and were issued in March of 1998. In August 2005, the U.S. Treasury released proposed cost- sharing regulations, which were intended to provide further guidance to taxpayers choosing to enter into qualified cost - sharing arrangements (CSAs). The proposed regulations were motivated by the need to clarify and specify methods for determining the initial "buy- in" amount that is often required at the outset of a CSA. A buy- in is required if one of the parties contributes pre- existing intangible assets that it has solely developed into the pool of IP to be developed by subsequent research. These proposed regulations have yet to be finalized.
Transfer Pricing Scrutiny	The level of transfer pricing scrutiny is high, and the Internal Revenue

	Service has significant experience in dealing with transfer pricing audits. As indicated by the recent flurry of new and proposed regulations, recent U.S. court cases (Glaxo, Xilinx, Symantec), and docketed court cases (Medtronic), companies with valuable intangible assets are highly scrutinized in connection to their licensing transactions and CSAs.
Definition of Related Party	For corporations, the main criterion for association is more than 50% capital ownership or control, either directly or indirectly. Control is widely defined and includes voting power, the right to appoint the majority of the members of management, and control on the basis contractual arrangements.
Transfer Pricing Penalties	Penalties that might apply to the taxpayer are specified under Section 6662 of the IRC. If the taxpayer has documentation in place at the time it files its tax return of transactions that are the subject of an adjustment, and the documentation establishes that the taxpayer determined its pricing in accordance with a specified method under Section 482 that is reasonably applied, then no penalties will apply to that adjustment. A penalty equal to 20 percent of the adjustment will otherwise apply if the price initially charged in an inter- company transaction is 200 percent or more (or 50 percent or less) of the correct price determined under Section 482, and the net transfer pricing adjustment exceeds the lesser of $5 million or 10 percent of gross receipts. A 40 percent penalty otherwise applies if the price initially charged in an inter-company transaction is 400 percent or more (or 25 percent or less) of the correct price determined under Section 482, and the net transfer pricing adjustment exceeds the lesser of $20 million or 20 percent of gross receipts.
Advance Pricing Agreement (APA)	The IRS does have an Advanced Pricing Agreement (APA) Program. The APA Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC §1.482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method. Taxpayers can pursue unilateral, bilateral or multilateral APAs through this program.
DOCUMENTATION AND DISCLOSURE REQUIREMENTS	
Tax Return Disclosures	There is no general obligation to disclose with the tax return information on inter-company transactions. However, U.S. public companies subject to the oversight of the Securities and Exchange Commission do have disclosure requirements related to their inter -company transactions. Under Financial Accounting Standard 57 (FAS 57), companies are required to disclose: The nature of the relationship, a description of the transaction, the value of transactions, and any effects from changes in the method of establishing terms from those used in the preceding period.

Level of Documentation	There are ten requirements for complete contemporaneous documentation under §1.6662 - 6(d)(2)(iii)(B): 1. Overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services. 2. Description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under section 482. 3. Documentation explicitly required by the regulations under section 482, including any inter -company contracts, documentation (if applicable) of: a bona fide cost sharing arrangement, a market share strategy, correlative adjustments resulting from proposed setoffs. 4. Description of the transfer pricing method selected and an explanation of why that method was selected. 5. Description of the alternative methods that were considered and an explanation of why they were not selected. 6. Description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions. 7. Description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made. 8. Explanation of the economic analysis and projections relied upon in developing the method. 9. Description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return which would help determine if a taxpayer selected an applied a specified method in a reasonable manner. 10. A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.
Record Keeping	Because there is no requirement to have transfer pricing documentation, there is no requirement to keep transfer pricing documentation. Having transfer pricing documentation is potentially helpful in avoiding penalties stemming from transfer pricing adjustments, and must be submitted within 30 days of being requested to serve this purpose. Therefore, at a minimum it is prudent to retain the transfer pricing documentation for all years that are still open under audit.
Language for Documentation	There is no requirement to submit documentation in English, but this is almost always the case in practice.
Small and Medium Sized Enterprises (SME's)	An SME is not exempt from compliance with Section 482 of the IRC; however, if the volume of transactions is sufficiently low, penalties under Section 6662 of the IRC will not apply (as described above).
Deadline to Prepare Documentation	Documentation must be in place at the time the taxpayer files its tax return. Failure to provide contemporaneous documentation does not trigger a penalty in and of itself.
Deadline to Submit	The taxpayer must be able to provide documentation of its inter- company transactions within 30 days of a request from the IRS for such

Documentation	documentation in order for the documentation to protect it from potential penalties related to an adjustment (and, as stated, the documentation must have been completed prior to filing its tax return). Failure to provide contemporaneous documentation does not trigger a penalty in and of itself.

STATUTE OF LIMITATIONS

As a general rule, the IRS must assess tax, or file suit against the taxpayer to collect the tax, within three years after the return is filed [IRC Sec. 6501(a)]. The three-year period of limitation on assessment also applies to penalties.

An extended six-year statute of limitations on assessment applies to returns that omit a substantial amount of gross income [IRC Sec. 6501(e)]. The extended statute gives the IRS extra time to identify and assess a deficiency in situations where the taxpayer's return gives no clue to the existence of the omitted income.

TRANSFER PRICING METHODS

Section 1.482 specifies methods for documenting transactions that largely parallel those specified in the OECD Transfer Pricing Guidelines.

For tangible goods transactions, taxpayers can use one of five specified methods: the CUP method, the resale price method, the cost plus method, the profit split method and the comparable profits method (similar to the transactional net margin method under the OECD Guidelines).

For intangibles, taxpayers can use of three specified methods: the CUT method (comparable uncontrolled transaction, similar to the CUP), the profit split method and the comparable profits method.

For service transactions, taxpayers can use one of six specified methods: the service cost method, the comparable uncontrolled service price method, the gross services margin method, the cost of services plus method, the comparable profits method, and the profit split method. Other unspecified methods may also be applied, and should be applied if they lead to a more reliable arm's length result.

Taxpayers are required to choose the "best method," defined as the method that leads to the most reliable arm's length result.

COMPARABLES

The I.R.S., in general, utilizes Standard & Poor's Compustat and Global Vantage databases to perform analyses using comparable companies. While it prefers that taxpayers use these databases, other databases have been accepted, including Bureau van Dijk's OSIRIS, Amadeus, Jade, and Fame databases, and Worldscope databases.

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