



# Introduction to U.S. Transfer Pricing

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# Outline



- What is Transfer Pricing?
- Conceptual Framework
- Comparability
- Section 6662 Penalty

# Legal Basis for Transfer Pricing

The Statute: [IRC §482](#) (emphases mine)

- In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) *owned or controlled directly or indirectly by the same interests*, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. [\[Since 1954\]](#)
- *In the case of any transfer (or license) of intangible property (within the meaning of Code Sec. 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.* [\[added in 1986\]](#)

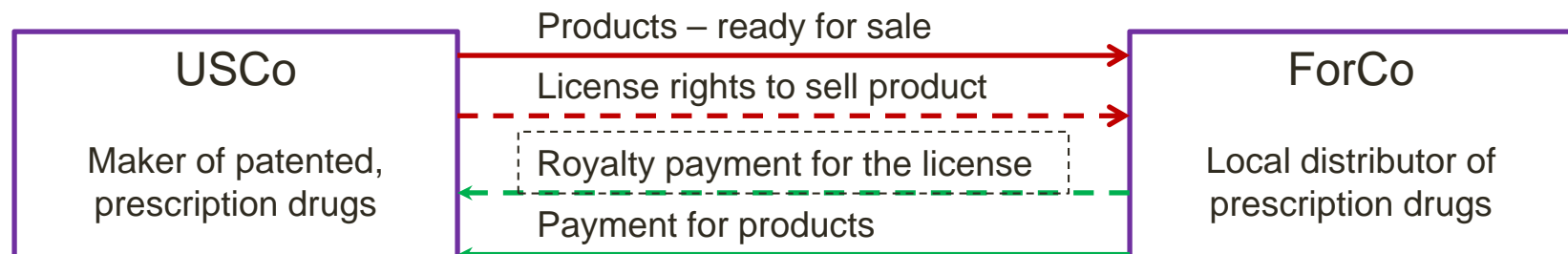
Regulations under [Treas. Reg. §1.482](#) introduced the “arm’s length standard”

- A controlled transaction meets the *arm's length standard* if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances [\[finalized in 1994\]](#)

# Controlled Transactions

Controlled transactions are subject to the transfer pricing regulations

- A sale transaction is “controlled” if there is no conflict of interest between the parties in setting the price
  - This may be the case if one party owns the other: (“left pocket, right pocket”)
- A transaction may be controlled even if the parties do not have any common ownership
  - Parties may have transactions in other jurisdictions and trade off prices to get tax advantages
  - Or may have collateral transactions and negotiate as a bundle
  - In the example below, USCo and ForCo are completely unrelated, but USCo may want to set higher royalties to maximize its foreign source income. If the form of payment, royalty versus product price, makes no difference to ForCo, the parties may set higher than arm’s length royalties



# More examples: controlled or not?

Examples of “controlled” transactions that may be subject to transfer pricing:

- USCo, a U.S. corporation, has a fully-owned subsidiary, CFC1. USCo sells products to CFC for resale in CFC’s jurisdiction. The price from USCo → CFC is subject to transfer pricing rules
- USCo negotiated and established a 50-50 joint venture (JV) in Singapore with an unrelated third party, SingCo, to manufacture and sell products in Asia. As part of the JV arrangement, USCo provided technology to JV on a royalty free basis. Is this transaction subject to transfer pricing rules? Probably not, as the JV arrangement is between unrelated parties.
- Two years later, USCo entered into a requirements agreements to purchase products from JV. Is this transaction subject to transfer pricing rules? Probably not, but worth checking if USCo “controls” JV, and whether there may be a lack of conflict of interest in setting the supply prices.
- USCo has a direct export customer in CFC’s country of incorporation. USCo asked CFC to be the employer of record for its local liaison personnel . Is there a transaction subject to transfer pricing rules? CFC performing a service on behalf of USCo, it must receive an arm’s length service fee.

# Why is Transfer Pricing Different/Important?

- Somewhat subjective application of the rules – not any method, but the “best method”
  - Many choices, adjustments in applying the “best method”
  - Results typically expresses as a range, “arm’s length range,” not a point
- Potentially large adjustments and penalties – especially in the Life Sciences and Technology industries
- Main focus in the “[Base Erosion and Profit Shifting](#)” initiative of the OECD countries
- Double taxation exposure: international differences – transfer pricing is always a two-sided, bilateral issue, and not all countries have the same transfer rules, or interpret and enforce them in the same manner. Double taxation of income drastically increases companies effective tax rate “ETR” which is visible and closely monitored by stock analysts
- Double tax relief is available for treaty partner countries
- Risk of double taxation impacts financial statements. Therefore, transfer pricing figures prominently in Sarbanes-Oxley § 404 compliance, internal audit, and financial reporting. Under the US GAAP, companies are obligated to set up FIN 48 reserves for uncertain tax positions and transfer pricing is the source of most tax uncertainties

# How to get my arm's around it?


## Section 482 Concepts: How to set your transfer prices at arm's length?

- Arm's length standard
- Factual development
  - Functional analysis
  - Risk analysis
  - Intangibles
- Transfer pricing methods
- Best method rule
- Application of the best method
  - Determination of comparability
  - Financial analysis of the comparables
- Arm's length range for transfer prices

## Section 6662 Concepts: Compliance and documentation


- Annual documentation report
- Penalties
  - Substantial valuation misstatement
  - Gross valuation misstatement
  - Good faith exclusion

# Conceptual Framework

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- Arm's Length Standard
  - Best Method Rule
  - Transfer Pricing Methods
  - Comparability
  - Arm's Length Range




# The Arm's-Length Standard

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- An intercompany transaction is arm's length if the results are the same as results that uncontrolled taxpayers would have realized if they were engaged in the *same* transaction under the *same* circumstances
    - "Identical" uncontrolled transactions generally not available
    - However, "*comparable*" uncontrolled transactions can be identified and financial data about the "results" of such comparable uncontrolled transactions can be obtained from taxpayer's own documents or publicly available resources
    - Arm's length standard requires us to do a hypothetical analysis to estimate what prices or profit margins would have been if the controlled transaction was *uncontrolled*
  - Identification and financial analysis of comparable uncontrolled transactions are at the center of all transfer pricing analysis
  - The arm's-length standard is the fundamental basis of worldwide transfer pricing regulations
  - U.S. regulations do *not* require taxpayers to structure their controlled transactions in the same manner as unrelated parties – there is no requirement that a controlled transactions must have an uncontrolled analog as long as
    - The transaction has economic substance, meaning that there is a reasonable basis for the parties to engage in the transaction
    - Transfer prices used for the transaction generate arm's length results


# Arm's Length Standard Examples

- Almost all independent contract manufacturers charge their customers fixed, per kilo or per count prices for active pharmaceutical ingredients . CFC manufactures active pharmaceutical ingredients for USCo on a cost-plus basis. Is CFC's transfer prices arm's length?
  - Controlled taxpayers do not have to follow the same contracting form as unrelated parties. Whether the transfer prices are arm's length or not depends on the level of the cost plus margin applied
- Almost all pharmaceutical licensing arrangements involve an upfront fee and/or milestone payments. USCo licenses such a product to CFC2 without requiring an upfront fee or milestone payments. Is USCo's licensing to CFC2 arm's length?
  - Could well be. As a tradeoff for not having upfront and/or milestone payments, the licensee may have agreed to higher running royalty rates. The question would then be a quantitative one: is the higher royalty rate enough to
- CFC3 is a wholly-owned subsidiary of USCo. CFC3 has no R&D expertise and employs only one finance manager. CFC3 purchased from USCo the worldwide rights to a drug under development and engaged USCo as a contract R&D service provider for its further development. What are the transfer pricing issues?
  - Should consider the appropriateness of economic substance – would CFC3 have appropriate control over the development process? If not, would it make sense for CFC3 to enter into this type of an arrangement?


# Transfer Pricing Methods

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- Arm's length principle is applied through different methods that evaluate *comparable uncontrolled transactions* at different levels of financial results (I emphasize this in blue and square bracket additions):
    - price,
    - gross profit
    - operating profits (i.e., earnings before interest, taxes, and non-recurrent items), or
    - residual profit (i.e., operating profits after deducting industry standard returns))
  - Tangible Property
    - Comparable Uncontrolled **Price** (CUP) Method
    - Resale Price **[Gross Margin]** Method (RPM)
    - **[Gross]** Cost-Plus **[Margin]** Method
    - **[Gross, Operating, Residual]** Profit Split Method
    - Comparable **[Operating]** Profits Method (CPM)
  - Intangible Property
    - Comparable Uncontrolled Transactions **[Price]** (CUT) Method
    - Market Capitalization **[Price]** Method
    - Acquisition **Price** Method
    - **[Gross, Operating, Residual]** Profit Split Method
    - Comparable **[Operating]** Profits Method (CPM)
    - **[Operating]** Income Method
  - Services Transactions
    - Comparable Uncontrolled Services **[Price]** Method
    - **[Gross]** Services **Margin** Method
    - Services Cost Method
    - **[Gross]** Cost of Services Plus **Margin** Method
    - Comparable **[Operating]** Profits Method for Services
    - **[Gross, Operating, Residual]** Profit Split Method


# Best Method Rule

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- No hierarchy of methods specified – all must be evaluated on their merits
  - “Best method” provides the *most reliable* measure of the arm’s-length result
  - Best method varies depending on facts of the case, as well as the availability of taxpayer’s own data and data for potentially comparable uncontrolled transactions
  - If no clear best method, convergence of results from multiple methods must be sought
  - Enough to make a reasonable evaluation of the applicable methods and pick a single method as the “best method,” to satisfy the “best method rule,” which is one of the 8 requirements for satisfying the documentation requirement under Treas. Reg. §1.6662
  - For the purposes of setting a robust policy that may stand challenges in a tax examination, however, my recommendation is to apply all applicable methods for which there is available data
    - Even though some of them may have been ruled out as unreliable, it is best to know what kind of an arm’s length range they may imply
    - There is no need to include the application of the secondary methods in your annual documentation
  - In rare cases, a taxpayer may have some specific facts and data that may allow the application of an “unspecified” method. A taxpayer relying on an unspecified method must show that the “unspecified” method is more reliable than all specified methods
    - In my experience, it is best to cast a potentially unspecified method as one of the specified methods. The universe of specified methods has been sufficient for hundreds of transfer pricing analysis I have performed, or supervised


# How to Apply the Best Method Rule?

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- Identify the comparable uncontrolled transactions (benchmarks) that may potentially be used in the application of each method
    - The same uncontrolled transactions may be used in multiple methods – consider USCo selling widgets to its related party distributor, CFC1, as well as unrelated distributors located in other countries. USCo’s sales to unrelated distributors would constitute comparable uncontrolled transactions. They may be used in the application of the CUP, Gross Cost Plus Margin, CPM, or Profit Split Methods.
  - Assess the degree of comparability between controlled and uncontrolled transactions under each method
    - Methods that use higher level financial data require more strict comparability – you need higher level of comparability to compare prices, but less for comparing operating or residual profits. In the example above, CUP cannot be applied unless USCo sells the same or highly similar products to both related and unrelated distributors, but the Gross Cost Plus Method can be reliably applied even if the products are different
  - Assess the completeness and accuracy of data available for the application of each method
  - Review the number and reliability of assumptions that need to be made to apply the method
  - Review the number and extent of adjustments needed for a reliable application of each method
  - Assess the sensitivity of results to deficiencies in data and assumptions


# Comparability

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- Uncontrolled transactions must be *sufficiently similar* to controlled transactions to provide a reliable measure of the arm's-length result
  - Five Factors:
    1. Nature of property or services transferred
    2. Contractual terms
    3. Functions performed
    4. Risks assumed
    5. Economic and financial conditions
  - Each transfer pricing method places different degrees of priority on these factors
    - CUP method would require close comparability on all counts
    - Gross margin methods may better tolerate differences in products and services
    - For profit split and operating profit based methods, product comparability or contractual terms may not matter as much

# Comparability Example

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- Reconsider the example of USCo selling prescription drugs (subject to patent protection) to CFC1 for distribution in CFC1's local market
  - For the USCo → CFC1 transaction, local tax administration asserted that a number of uncontrolled co-promotion agreement would be a good comparable transactions
  - In an uncontrolled co-promotion agreement, Company A has the local rights to product A and supplies product A to Company B at cost for resale. Company B is responsible for securing local approvals, sales and distribution. Both Company A and Company B share detailing and other promotion activities and their costs. Company B pays Company A 50 percent of the gross profit as the co-promotion payment
  - In the controlled transaction, the sales price is set to leave CFC1 with an operating margin (ratio of operating profits to net sales) of 5 percent, supported by an application of the CPM, thereby USCo guarantees full cost recovery and a profit margin for CFC1's opportunity cost
  - Therefore, USCo → CFC1 transaction differs from an uncontrolled co-promotion arrangement in terms of the *contractual terms and risks assumed by CFC1*

# Comparability -- Functions

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- **Functions Performed:** Degree of comparability requires comparison of functions performed and associated resources employed including the type of assets used.
    - Research and development (R&D)
    - Product design and engineering
    - Product fabrication, extraction, and assembly
    - Procurement
    - Marketing and distribution functions
    - Transport and warehousing
  - In some cases, an entity may get credit for a function if it outsources it to a third party (related or unrelated)
    - In such cases, OECD, U.S. Treasury and many local tax authorities are increasingly focusing on “control” as an important function
    - To get full credit for an outsourced function, a taxpayer is expected to exercise a meaningful level of control over that function, such as setting the budget, providing guidance, periodically checking on the performance
    - In an earlier example, CFC3 had engaged USCo to perform R&D on an outsourced basis. Even though CFC3 may provide all the funding and pays USCo an arm’s length service fee, it may not be credited with the R&D if it delegates all critical decisions to USCo




# Comparability -- Functions



Attribution of a function to a party that does not perform most of that function, but takes on the associated risks and controls is the linchpin of the U.S. contract manufacturing regulations. Below is a high-level, informal description of the seven criteria for being considered a “manufacturer” without performing the actual manufacturing.

1. Oversight and direction of the activities and process pursuant to which the property is physically manufactured;
2. Activities that are considered in, but that are insufficient to qualify as physical manufacturing;
3. Material selection, vendor selection, or control of the raw materials, work-in process or finished goods;
4. Management of manufacturing costs or capacities (for example, managing the risk of loss, cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling or hedging raw material costs);
5. Control of manufacturing related logistics. Note that this activity would include arranging delivery of raw materials, but would not include post-manufacturing logistical activities: for example, arranging the shipment of finished goods to customers;
6. Quality control (for example, sample testing or establishment of quality control standards); and
7. Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology or other intellectual property for the purpose of physically manufacturing the property.

# Comparability – Contractual Terms

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- Comparison of significant contractual terms that could affect the results of the two transactions is an important comparability criterion:
    - Form of consideration charged or paid: lump-sum versus running royalty
    - Sales or purchase volume, volume guarantees (take-or-pay contracts)
    - Warranties, guarantees, and indemnities
    - Duration of agreement, termination rights, and rights upon termination
    - Credit and payment terms
    - Delivery terms
  - Written agreement vs. no written agreement: Under the U.S. regulations, taxpayers do not have to follow common industry practices, as long as they have a prior written agreement in place or display consistent conduct over time.
  - The U.S. Treasury Regulations §1.482-1(d)(3)(ii)(B)(1) put forth that the contractual terms will be respected if they are “consistent with the economic substance” of the underlying transaction.
  - Whenever the current contractual terms or parties’ prior conduct are silent on the allocation of a specific risk or issue, U.S. Treasury Regulations §1.482-1(d)(3)(ii)(B)(2) suggests to seek guidance from “established industry convention or usage.”

# Comparability – Risks Assumed




- Comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions
  - Product development risks (funding R&D without guaranteed success)
  - Patent infringement risks
  - Market development risks (SG&A spending without guaranteed or short-term orders)
  - Volume risks (variability of demand for products)
  - Margin/ cost risks (variability of costs of manufacturing or sales and marketing)
  - Inventory risks that inventory at hand may be destroyed, lose value, or become obsolete
  - Product liability risks asserted for defective manufacturing, design, or failure to warn
  - Regulatory and legislative risks (e.g., government reimbursements, regulations, changes in patent protections)
  - Financial risks (e.g., foreign exchange)
  - Credit and collection
  - General business risks (e.g., restructurings, employee claims, willful misconduct, breach of law)
- Identification of taxpayer that bears risk – Treas. Reg. generally respects the contractual terms unless agreement conflicts with economic substance of transaction (see the next slide)


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# Comparability – Economic Conditions

- 
- Comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions.
    - Geographic markets
    - Relative size and maturity of markets
    - Level of market (e.g., wholesale vs. retail)
    - Market share
    - Location-specific costs, or availability of location cost savings
    - Competition
    - Industry conditions
  - Geographic markets: In many cases, potentially comparable uncontrolled transactions may occur in a different market.
    - It is common for mid-size multinationals to use independent distributors in smaller or less developed markets (so as to avoid the fixed costs of setting up and operating a wholly-owned subsidiary)
    - Comparability adjustments should be considered to use such transactions with independent distributors in smaller markets as comparables for controlled sales to wholly-owned distributors in larger markets (such as adjustments for operating leverage, cost of capital, and opportunity cost differences)

# Comparability – Economic Downturn

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- Economic downturns or recessions have disparate effects on different industries. Some suffer more than others while a few may experience brisk growth
  - Requiring that comparable transactions or companies be affected from the economic downturn in the same magnitude and/or manner becomes an additional and important comparability criterion
  - This additional comparability requirement may eliminate a large number of comparable transactions or companies – in some cases, there may not be any comparables left
  - Various techniques can be used to get more samplings of companies suffering from recessionary impacts:
    - Go back to earlier economic downturns to get pull more relevant data on
    - Consider statistical methods to quantify the impact of the economic downturn on prices and/or profit margins

# Comparability – Location Savings

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- China, India, most countries in Southeast Asia, Poland and other Eastern European countries offer significantly lower manufacturing costs for certain industries
  - In many cases, it may not be possible to identify comparable local manufacturing companies that have the same capabilities as the local controlled manufacturing subsidiaries
  - U.S. transfer pricing rules allow controlled manufacturing subsidiaries located in low-cost jurisdictions to retain some or all of the cost savings “if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.” Treas. Reg. §1.482-1(d)(4)(ii)(C)
  - In practice, this condition would generally be satisfied if the taxpayer cannot potentially outsource the manufacturing activities performed by the controlled manufacturing subsidiary to unrelated (independent) manufacturers operating in the same or similar markets
    - In the apparel industry, there are many independent enterprises operating in low-cost countries, with good track records and capabilities. Therefore, it will be hard to argue that a local subsidiary should keep a significant portion of the location savings (except for the high-end of that industry)
    - In life sciences, there are many independent manufacturers in India or other low-cost jurisdictions, but their ability to consistently meet FDA requirements is somewhat limited. Thus a highly capable local manufacturing subsidiary in India, or a similar jurisdiction, may be able to retain significant geographic cost savings.

# Comparability – Product/Service/IP

- Comparison of the attributes of products, services, and IP subject to the transfer such quality, features, capabilities, profit potential and embedded intangibles
- Product/service/IP comparability must be evaluated together with the intended method
  - CUP or CUT require the highest level of comparability – it is hard to meet comparability without having identical tangible products, or services. For IP, a careful evaluation of the profit potential is needed, besides confirming similarity in terms of the nature of the IP, industry, potential applications
  - Resale Price and Cost Plus methods require some level of similarity of products or services
  - CPM is most forgiving in terms of working with comparable transactions involving somewhat similar products
- For products or services, one of the most significant points of comparison would be the level of embedded intangibles
  - The transfer price for a prescription drug without the patented sell rights would normally be a cost-plus price, with the plus element capturing the return for manufacturing. The same product with the patent sell rights would be priced on a resale price basis, at multiple of costs
  - The transfer price for a soda or a beer without any branding would normally be a cost-plus price, with the plus element capturing the return for manufacturing. The same product with the brand may well be worth twice or more of that amount depending on the strength of the brand



# Comparability Example

CFC1 sells all of USCo's products in Germany, under a targeted profitability regime (USCo prices products so that CFC1 covers all of its expenses and earns a 5 percent operating profit). USCo also sells its *oncological* products to Company B, an independent distributor, for resale in Poland and other Eastern European markets at 50 percent of the resale price

- Functions: CFC1 and Company B perform the same/similar range of activities
- Contractual terms: Significantly different
- Risks assumed: Company B assumes more significant risks than CFC1 (such as product liability risks related to the marketing of the products)
- Economic conditions: Germany and Eastern European markets may have different economic attributes, must also consider that Eastern Europe territory includes a large number of smaller economies, presenting a different operating leverage model than Germany
  - Pricing (reimbursement) policies of the governments
  - Promotion and marketing costs as a percentage of the average net selling price
- Product comparability: different products, different therapeutic areas, it is important to compare
  - Margins for the different products (do oncology products earn higher margins, all else being equal?)

# Comparability - Adjustments




- It is unusual for companies to satisfy all comparability requirements
- Adjustments to the financial data of comparable companies can often compensate for different levels of assets and expenses
- The same adjustments must also be applied to tested party financials (i.e., to the financial results of the taxpayer entity that is included in the analysis)
- Adjustments *must* be made to enhance comparability if the effect of differences can be determined with sufficient accuracy to improve the reliability of results
- Number and magnitude of adjustments affects reliability of results
- Common Adjustments include:
  - LIFO and FIFO inventory valuation adjustment
  - Adjustment for amortization of intangibles
  - Adjustments for pension cost differences
  - Working capital adjustments (e.g., accounts receivable, accounts payable, and inventory)

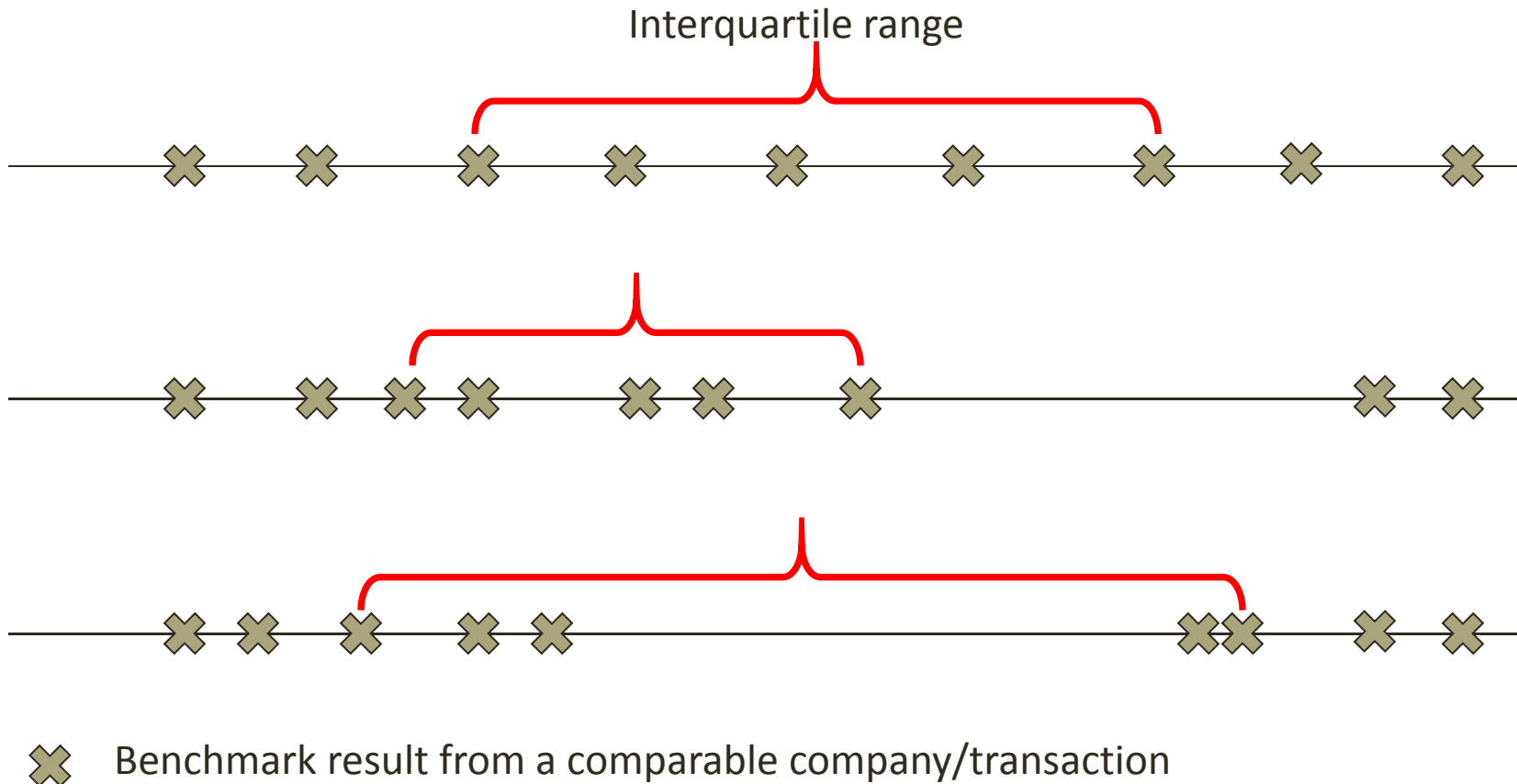
# Comparability – Special Adjustments

- **Adjustments for functional intensity**
  - A controlled distributor may perform more functions and incur higher levels of SG&A-to-sales expenses than the comparable distributors
  - Determine the returns attributable to incremental (or excess) functions and add them to the benchmark returns
- **Volume discounts**
  - Only in CUP, resale, cost-plus methods, when the controlled transaction volume is significantly larger (or smaller) than uncontrolled transactions
  - Must get evidence about the levels of volume discounts provided in the industry
- **Risk level adjustments**
  - A controlled manufacturer supplying products on a cost-plus basis would have lower level of risk than an independent manufacturer making and selling products at fixed prices
  - This adjustment requires identification of capital at risk and differential returns for risk-mitigated business activities
- **Embedded intangibles**
  - A controlled sale of a product may include embedded intangibles (such as brands) while an uncontrolled sale may not
  - Identify the return attributable to embedded intangibles (e.g., trademark royalty) and add that to the supplier's benchmark profit margin
- **Adjustments for FX risks**
  - A controlled distributor for Europe purchases products from USCo in U.S. dollars, but the comparable distributors conduct most of their transactions in Euros. It is customary in this industry to get longer term, fixed price contracts
  - Controlled distributor assumes a higher level of risk than the comparable companies, but the controlled distributor can purchase a hedge in financial markets. The risk adjustment should consider the cost of such a hedge

# Benchmark Range

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- In most cases it is not possible to identify a single price that would occur between unrelated parties
  - Arm's-length range results from use of two or more uncontrolled transactions of similar reliability and comparability
  - Uncontrolled transactions with less reliability or comparability must be discarded
  - No adjustment if results of controlled transaction is within arm's-length range
  - Under restrictive rules regarding comparability and adjustments, the arm's-length range is "full range"
  - When there are material differences between comparables and controlled transactions for which adjustments cannot be made, narrowing of the range is used to increase the reliability of results
  - Generally use the interquartile range – middle 50 percent of observations – remove top 25 percent and bottom 25 percent

# Interquartile Range Examples

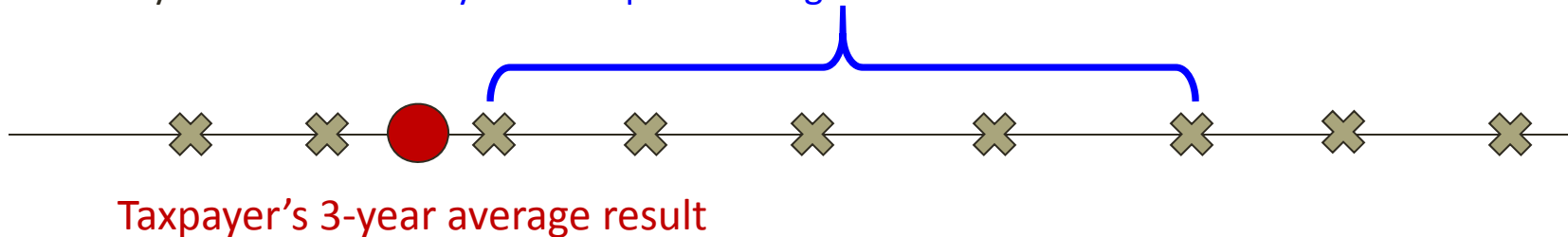


# Miscellaneous

- Multi-year data:
  - CPM requires the use of multi-year data to smooth out variations due to business cycles. Normally, 3-year average is used unless the taxpayers shows that a longer or shorter time period would be more reliable
  - For other methods, taxpayer may use multi-year data, but would need to show that multi-year averaging is more reliable than using single year data
- “Market share” strategy – U.S. regulations allow taxpayers to deviate from arm’s length prices for a period of time to pursue specific business objectives as long as the “market share” strategy is put in place in writing, upfront, and with a reasonable mechanism of recovery of losses sustained. Treas. Reg. §1.482-1(d)(4)(ii)(C)
  - Controlled taxpayers must agree on the market share strategy (preferably in writing) before initiating it
  - The controlled taxpayer that will bear the losses must have a reasonable expectation of cost recovery and a normal rate of return
  - Market share strategy cannot be pursued indefinitely
- Setoffs versus aggregation: they are not the same!
  - Setoffs apply for adjustments made to two or more transactions between the same taxpayers. Assume that USCo sells products to CFC1 and also provides support services to CFC1. If USCo or the IRS determines that USCo was earning above arm’s length profits on product sales, and below arm’s length profits on services, the two adjustments may offset each other. If only one transaction’s results are outside the arm’s length range, there will be no setoff
  - Aggregation requires that two or more transactions between the same two taxpayers are so intertwined that they can only be analyzed on an aggregate basis

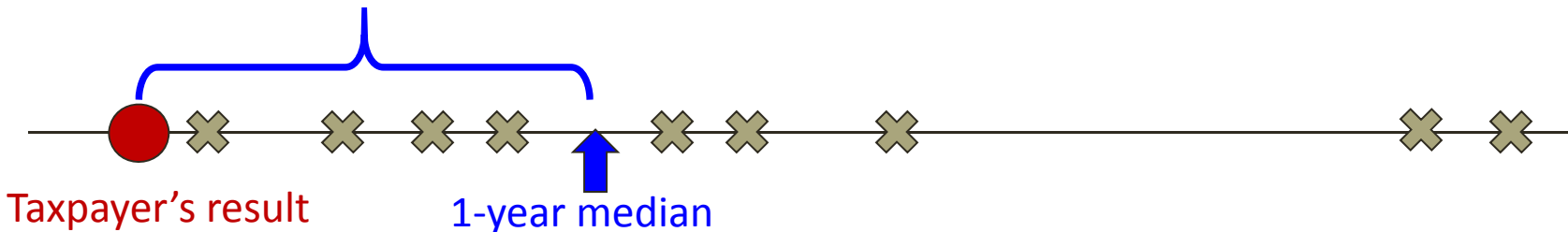
# Transfer Pricing Adjustment

- Multi-year test: 3-year interquartile range



- If the taxpayer fails the multi-year test, the adjustment is calculated based on the 1-year results versus the 1-year median for the tax year under exam or audit

Transfer pricing adjustment



- If taxpayer's result for the audit year is greater than the 1-year median, there will be no adjustment
- Even if the taxpayer's single year results falls within the single-year range, but below the median, there will still be a transfer pricing adjustment


# Section 6662 Penalty

	Transactional	Net Adjustment
Substantial Valuation (20% penalty)	Price or value is 200% or more (50% or less) than the correct amount	Net adjustment exceeds the lesser of \$5 million or 10% of gross receipts
Gross Valuation (40% penalty)	Price or value is 400% or more (25% or less) than the correct amount	Net adjustment exceeds the lesser of \$20 million or 20% of gross receipts

- While the penalty percentage is determined with reference to the transfer pricing adjustment amount, penalty is applied only on the amount of additional taxes payable
- If a taxpayer has enough loss carryforwards to cover additional taxes resulting from the transfer pricing adjustment, no penalty will be applied



# Section 6662 Penalty

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- Good Faith Exclusion:
    - The valuation misstatement penalties may be waived if a taxpayer can show good reason to believe the company was following the arm's-length standard in application of the transfer prices.
  - Two elements are required for the “Good Faith Exclusion:”
    - Reasonable effort (to establish the arm's-length nature of prices)
    - Reasonable belief (that the transfer pricing methodology produced an arm's-length result)
  - A taxpayer may gain reasonable belief through reliance on a professional tax advisor

# Section 6662 Documentation

- Ten principle documents required to fulfill contemporaneous documentation requirements:

## BUSINESS DESCRIPTION

1. Overview of taxpayer's business
2. Description of [legal entity] organizational structure
3. Documentation explicitly required under Section 482 (such as license agreements, or qualified cost share documentation)

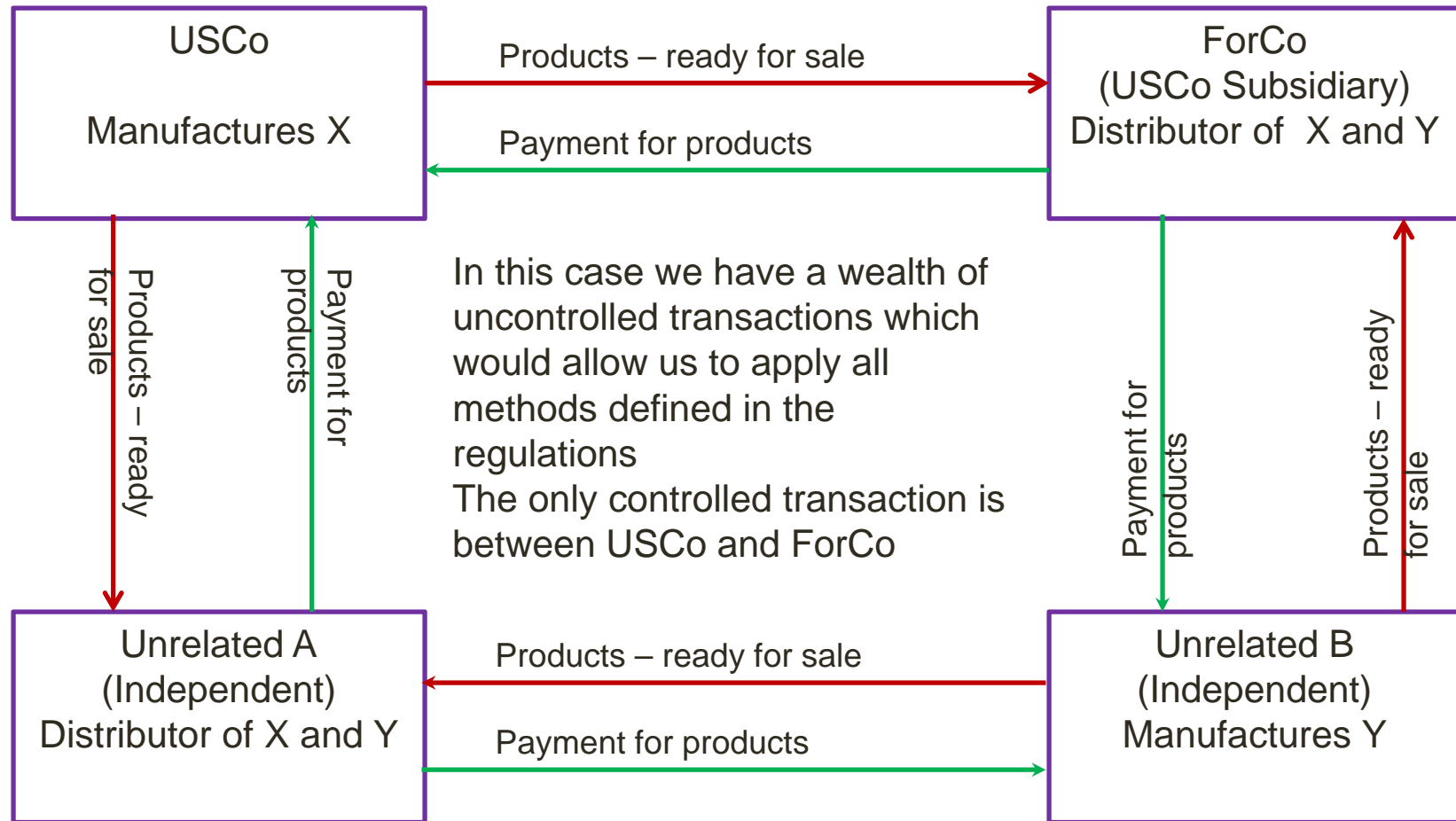
## BEST METHOD ANALYSIS

4. Description of method selected and reason for selection
5. Description of alternative methods not used, and reason for not using them

## FUNCTIONAL , RISK AND ECONOMIC ANALYSIS

6. Description of controlled transactions and internal data
7. Description of comparables and adjustments (if any)
8. Explanation of economic analysis and projections used
9. Description of data obtained after tax year and before filing return
10. General index of documents

# Applying Methods: Case Study



# Case Study -- Financials

Controlled Transaction	<u>USCo</u>	ForCo	<u>Consolidated</u>
Sales	_____	20,000	20,000
COGS	< 6,000 >	< _____ >	< 6,000 >
Gross Profit (Margin)	_____ ( __%)	_____ ( __%)	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	_____ ( __%)	_____ ( __%)	9,000 (45%)

Uncontrolled	<u>USCo (Sales to A)</u>	ForCo (Resales of Y)
Sales	12,000	20,000
COGS	< 6,000 >	< 14,000 >
Gross Profit (Margin)	6,000 (50%)	6,000 (30%)
SG & A	< 3,000 >	< 4,000 >
Operating Profit (Margin)	3,000 (25%)	2,000 (10%)

# Case Study – Financials Discussion

- **Controlled transaction: sales of X from USCo to ForCo**
  - We need to determine transfer prices to build the full financials: USCo sales and ForCo's COGS is determined by transfer pricing
  - Their consolidated margin is at 45 percent
- **USCo's uncontrolled sales of X to independent company A:**
  - USCO earns a gross margin of 50 and an operating margin of 25 percent
  - Lower than the consolidated margins – makes sense as USCo is only doing manufacturing
  - These data points can be used for the application of the Cost-Plus method
- **ForCo's uncontrolled purchases of Y from independent company B:**
  - ForCo earns a gross margin of 30 and an operating margin of 10 percent
  - Lower than the consolidated margins – makes sense as ForCo is only doing distribution
  - However, it appears that product Y is more expensive and requires more SG&A effort to sell
  - These data points can be used for the application of the Resale Price method
- **Uncontrolled sales of Y from independent company B to independent company A**
  - A and B are public companies – their overall financials, as well as net sales of products are in the public domain
  - Based on their financials, they appear to be splitting operating profits on a 50-50 basis
  - This data point will be used for the application of the Comparable Profit Split method

# CUP

Controlled Transaction	<u>USCo</u>	ForCo	<u>Consolidated</u>
Sales	<u>12,000</u>	20,000	20,000
COGS	< 6,000 >	<u>&lt; 12,000 &gt;</u>	< 6,000 >
Gross Profit (Margin)	<u>6,000 (50%)</u>	<u>8,000 (40%)</u>	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	<u>4,000 (33.3%)</u>	<u>5,000 (25%)</u>	9,000 (45%)

- Use USCO's uncontrolled sales price of X to independent company A
  - Note that USCo's COGS on a per unit basis would be the same. As its COGS for supplying ForCo versus A is the same, so must be the sales volume
  - Therefore, we can directly use USCo's net sales to A as our CUP benchmark
- We can directly fill in the sales line for USCo, which will also be ForCo's COGS
- All other margins can be calculated
- Note that the CUP method gave both entities higher profit margins than the margins they got from their respective uncontrolled transactions

# Resale Price

Controlled Transaction	<u>USCo</u>	ForCo	<u>Consolidated</u>
Sales	<u>14,000</u>	20,000	20,000
COGS	< 6,000 >	< <u>14,000</u> >	< 6,000 >
Gross Profit (Margin)	<u>8,000 (67%)</u>	<u>6,000 (30%)</u>	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	<u>6,000 (43%)</u>	<u>3,000 (15%)</u>	9,000 (45%)

- Use ForCo's uncontrolled gross margin on re-sales of Y purchased from independent company B: 30%
- 30% gross margin implies a gross profit of \$6,000 for ForCo, which in turn implies COGS of \$14,000 (which would also be USCo's sales)
- This method gives USCo more profits than the CUP method because USCo sells product X, which is apparently cheaper to make, at a the same price point as Y
- Clearly there is a profit potential difference between X and Y, rendering this method somewhat less reliable than the CUP method

# Cost Plus

Controlled Transaction	<u>USCo</u>	ForCo	<u>Consolidated</u>
Sales	↑ <u>12,000</u>	20,000	20,000
COGS	< 6,000 >	↓ <u>&lt; 12,000 &gt;</u>	< 6,000 >
Gross Profit (Margin)	<u>6,000</u> ← (50%)	↓ <u>8,000</u> (40%)	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	↓ <u>4,000</u> (33%)	↓ <u>5,000</u> (25%)	9,000 (45%)

- Use USCo's uncontrolled gross margin on sales of X to independent company A: 50%
- 50% gross margin implies a gross profit of \$6,000 for USCo, which in turn implies sales of \$12,000 (which would also be ForCo's COGS)
- This method gives the same result as the CUP method because we are using the same comparable uncontrolled transaction as the benchmark



# Comparable Profit Split

Controlled Transaction	<u>USCo</u>	ForCo	<u>Consolidated</u>
Sales	↑ <u>12,500</u>	20,000	20,000
COGS	< 6,000 >	↑ <u>&lt; 12,500 &gt;</u>	< 6,000 >
Gross Profit (Margin)	↑ <u>6,500 (54%)</u>	↑ <u>7,500 (40%)</u>	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	<u>4,500 → (38%)</u>	<u>4,500 → (22.5%)</u>	<b>9,000</b> (45%)

- Use the profit split observed between the independent companies A and B: 50%, and split total consolidated profits of \$9,000 between the parties
- Working backwards, calculate the gross profits, sales for USCo, and gross profits and COGS for ForCo
- Check that ForCo COGS equals USCo sales
- This method gives a slightly better result for USCo than the CUP method

# Comparable Profits Method –USCo Tested Party

Controlled Transaction	USCo	ForCo	Consolidated
Sales	10,667	20,000	20,000
COGS	< 6,000 >	< 10,667 >	< 6,000 >
Gross Profit (Margin)	4,667 → (44%)	9,333 → (47%)	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	2,667 ← (25%)	6,333 → (32%)	9,000 (45%)

- Tested party is selected to be USCo
- Normally, CPM is applied with external comparable companies, but in this case, we can use USCo's segmented financials on sales of X to independent company A: 25%
- As USCo's sales are controlled, instead of the operating margin, we use the net cost plus ("NCP") margin (please note that NCP margin = operating margin ÷ (1 – operating margin))
- Therefore, USCo's NCP margin is 33%, which is applied to the total cost base of \$8,000 (= \$2,000 + \$6,000), to calculate USCo's operating profits at \$2,667
- We get USCo's sales at \$10,667 (which is also ForCo's COGS) by adding the operating margin, SG&A and COGS
- We then calculate ForCo's gross profits at \$9,333 and operating profits at \$6,333
- This method provides the best result for ForCo, and the worst for USCo

## Comparable Profits Method – ForCo Tested Party



Controlled Transaction	<u>USCo</u>	ForCo	<u>Consolidated</u>
Sales	<u>15,000</u>	20,000	20,000
COGS	< 6,000 >	< <u>15,000</u> >	< 6,000 >
Gross Profit (Margin)	<u>9,000 → (60%)</u>	<u>5,000 → (47%)</u>	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	<u>7,000 → (47%)</u>	<u>2,000 ← (10%)</u>	9,000 (45%)

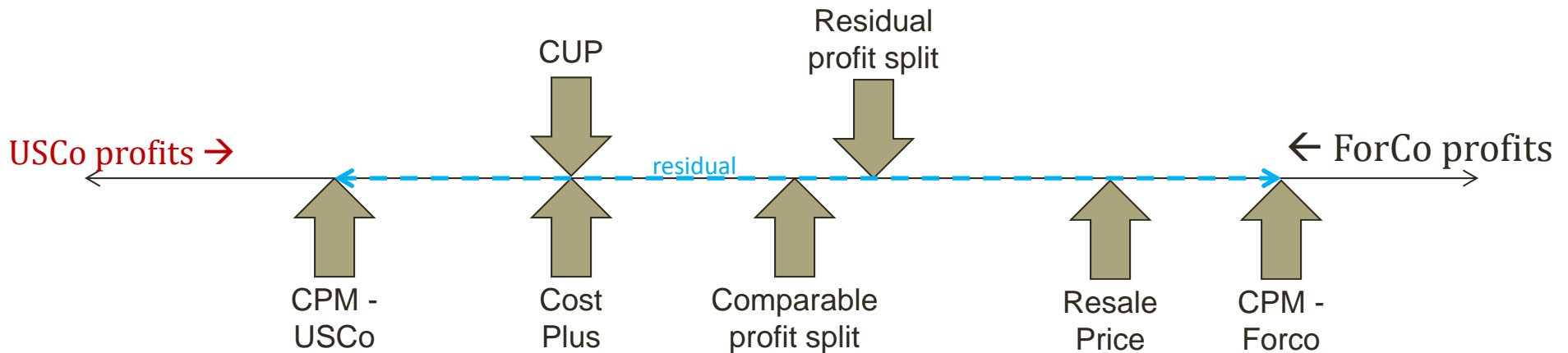
- Tested party is selected to be ForCo
- Normally, CPM is applied with external comparable companies, but in this case, we can use ForCo's segmented financials on resales of Y (purchased from independent company B): 10%
- Therefore, ForCo's Operating Profits would be \$2,000, working backwards, we calculate ForCo's gross profits at \$5,000, and COGS at \$15,000, which would also be USCo's sales
- We then calculate USCo's gross profits at \$9,000, and operating profits at \$7,000
- This method provides the best result for USCo, and the worst for ForCo

# Residual Profit Split

Controlled Transaction	<u>USCo</u>	ForCo	<u>Consolidated</u>
Sales	<u>12,834</u>	20,000	20,000
COGS	< 6,000 >	< <u>12,834</u> >	< 6,000 >
Gross Profit (Margin)	<u>6,834</u> → (53%)	<u>7,167</u> → (36%)	14,000 (70%)
SG & A	< 2,000 >	< 3,000 >	< 5,000 >
Operating Profit (Margin)	<u>4,834</u> → (38%)	<u>4,167</u> → (21%)	9,000 (45%)
Routine Profits (CPM)	<u>2,667</u>	<u>2,000</u>	<u>4,667</u>
Residual Profits	<u>2,167</u>	<u>2,167</u>	<u>4,333</u>

- Calculate routine profits based on CPM analyses, and the residual profit as the difference
- Allocate residual profits based on a reasonable indication of non-routine contributions of the parties (this is a bit advanced topic, for now we assume that this is a 50-50 split)
- Add routine and residual profits to calculate operating profits
- The rest is calculated going backwards from operating profits

# Discussion of the Results



- The results are completely driven by the specific economics of the example
- However, it is clear that USCo and Forco, on their consolidated basis X-business, do much better than their involvement with product Y, hence the large residual profit, which should belong to the party that owns intangibles and assumes risks (functions are compensated by the CPM results).
- Cost-Plus provides higher profits for USCo because USCo has lower SG&A expenses on its controlled sales (which is not surprising as related parties would not spend as much time on sales and marketing to each other)
- Similarly, Resale Price provides higher profits for ForCo because ForCo has lower SG&A per dollar of sales but the reason for that is driven by the economics