

International Tax Policy Forum / AEI Conference on
Locating the Source of Taxable Income in a Global Economy

Transfer Pricing is Not a Four Letter Word

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Agenda

- What is Transfer Pricing?
- Historic vs. Current Transfer Pricing Complexity
- Transfer Pricing Regulations and Guidelines
- Current Issues

What is Transfer Pricing?

A New Crime has been Defined in the U.S. and U.K.
ENGAGING IN TRANSFER PRICING

The New York Times

“The Internal Revenue Service claimed back taxes from Glaxo after saying that the company had engaged in ‘transfer pricing,’ a practice meant to minimize United States taxable profits by overpaying foreign subsidiaries for product supplies.” [9/12/06]

**The
Economist**

“Global companies have plenty of latitude to minimise their tax bills...[a] big stick in the corporate treasurer’s tax-avoidance armoury is transfer pricing.” [2/22/07]

What is Transfer Pricing?

- Transfer Pricing pertains to how related entities price tangible goods, intangibles, services, and loans among themselves.
 - Transfer Pricing rules and regulations are designed to prevent tax avoidance among related entities.
 - In an international context, transfer pricing rules serve to divide rights to tax income of MNCs between home and host countries.
 - All OECD member countries have rules governing inter-company pricing.
 - In the U.S., transfer pricing rules apply to both domestic and international related-party transactions.

The Arm's-Length Standard

- The arm's-length standard ("ALS") places a controlled party on parity with an uncontrolled party with respect to a specific transaction.
 - It is grounded on observing how unrelated parties in fact transact in the real world, not in theory.
- ALS is an international norm:

“The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues; and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases. This overwhelming evidence indicates that there in fact is an international norm for making transfer pricing adjustments and that the norm is the arm's length standard.” [1988 Treasury White Paper]

Historic Transfer Pricing Example

CFC grows pineapples in Cuba and sells them to its U.S. Parent.

There existed a world market, hence an arm's-length price can be determined easily and would control the transfer price and, hence, the division of profit.

The original transfer pricing regulations favored the Comparable Uncontrolled Price (“CUP”) method as the best method for determining the transfer price under the ALS.

- This remains the case in OECD/EU regulations.
- The U.S. claims to still embrace the ALS but tax auditors frequently dismiss CUPs and by regulation it specifies methods that many contend are inconsistent with the ALS.

Transfer Pricing Today



When a company in Country A transfers goods, services, or intangibles to a related company in Country B, the profits of each of the entities will depend on the price at which the goods are transferred. Similarly, the interest rate on an inter-company loan affects the profits of each entity.

If Country A and B disagree on the appropriate transfer price, the same income may be subject to tax in both jurisdictions. If a double taxation treaty exists between Countries A and B, the taxpayer may seek relief from double taxation through the mutual agreement clauses.

Modern Transfer Pricing Example

		<u>Costs</u>	
US Parent	Provides R&D	\$80	
Irish Sub	Provides Manufacturing	\$30	
Indian Sub	Provides Telephone CS	\$10	
German Sub	Markets/Sells in Germany	\$40	
	Sales Revenue to 3 rd Party		\$200
	System Profit		\$40

Modern Example Restructured with Swiss Entrepreneur

		<u>Costs</u>	
US Parent	Provides Contract R&D to Swiss subsidiary	\$80	
Irish Sub	Provides Contract Mnfg	\$30	
Indian Sub	Provides Telephone CS	\$10	
German Sub	Ltd Risk German Distributor	\$40	
	Sales Revenue to 3 rd Party		\$200
	System Profit		\$40

Swiss Sub bears all the risks and issues all the contracts

Transfer Pricing Regulations and Guidelines

- Internal Revenue Code Section 482 and Regulations
- Internal Revenue Code Section 6662(e) and Regulations (documentation and penalties)
- OECD Guidelines
- Local country rules (e.g., China, Germany, Vietnam, and Finland)
 - Transfer Pricing penalty regulations are adopted by more and more countries. Significant documentation and penalty requirements abound.
 - Transfer Pricing is now the focus of many international and state audits as well as Competent Authority negotiations and court cases (*GE Canada* and *Veritas* are the most recent decisions).

Overview of the Section 1.482 Regulations

Key concepts of Section 1.482:

- Arm's-length standard
- Arm's-length range
- Best method rule
- Comparability
- Pricing methods
- Commensurate with the Income (CWI) and Periodic Adjustments (“Look Back”) regulations

Overview of Section 1.482 Regulations

Arm's-Length Standard

- A controlled transaction meets the standard (Section 1.482) if the results of the transactions are consistent with results that would have been realized if an uncontrolled taxpayer had engaged in a similar transaction.

Best Method Rule

- Arm's-length result must be determined under the method that provides the most reliable measure of an arm's-length result .
 - Degree of comparability
 - Quality of data

Overview of Section 1.482 Regulations

Comparability Analysis 1.482-1(d)

- Comparison of functions performed by the taxpayer in each transaction, include:
 - Functions performed;
 - Contractual terms;
 - Risks affecting price/profit;
 - Economic conditions and the property or services transferred in the transactions;
- and
- Intangible property owned by the parties in the transaction.

Overview of Section 1.482 Regulations

Arm's-Length Range 1.482-1(e)

- Application of the transfer pricing method will produce either a single result or a number of results from which a range of reliable transfer prices may be derived.

Commensurate with the Income (Periodic Adjustments) 1.482-4(f)

- The arm's-length consideration for the transfer of a transferred intangible must be commensurate with the income attributable to the intangible. “If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted [by the IRS] to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph shall be consistent with the arm's length standard and the provisions of §1.482-1.”

Characterizing Entities

Why do we characterize entities for transfer pricing purposes?

- To utilize a common taxonomy
- To select and apply the appropriate TP methodology to the correct “tested party” (*i.e.*, subject of the analysis)

Types of entities

- Sales
- Manufacturing
- Services

An entity’s profitability is typically related to the functions, risks, and intangible assets associated with the transaction as issue.

OECD Transfer Pricing Guidelines

Approved in 1996

Member countries of the OECD

Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States

Taxpayers should make “reasonable efforts” to determine that transfer pricing is arm’s length.

Transfer Pricing Methods for Tangible Goods

Tangible

- Comparable Uncontrolled Price Method (“CUP”)
- Resale Price Method (“RPM”)
- Cost Plus Method (“Cost Plus”)
- Comparable Profits Method (“CPM”)
- Profit Split Method (“PSM”)
- Unspecified Methods

Transfer Pricing Methods for Intangibles

Intangible (subject to CWI adjustments)

- Comparable Uncontrolled Transaction Method (“CUT”)
- Comparable Profits Method (“CPM”)
- Profit Split Method (“PSM”)
- Methods for valuing Platform Contribution Transactions (“PCT”) for Cost Sharing
 - CUT Method
 - Acquisition Price Method
 - Residual Profit Split Method (“RPSM”)
 - **Income Method (NB: Veritas)**
 - Market capitalization method
 - Unspecified methods

New Specified Methodologies for Services

The Temporary Service Regulations create seven methods that can be applied to determine the arm's-length price for services transactions (including "costs" of equity compensation):

1. Services Cost Method (no mark-up implies safe harbor)
2. Profit Split Method
3. Comparable Uncontrolled Services Price Method
4. Gross Services Margin Method
5. Cost of Services Plus Method
6. Comparable Profits Method
7. Unspecified Methods

Current Issues

- Litigious Environment
- New Transfer Pricing Practice within the IRS
- JCT Recommended Changes to the TP Rules
- Cost Sharing Agreements (*Xilinx v. ALS*)
- Application of Commensurate With Income (“CWI”) Principle
- Business Restructuring
- Services

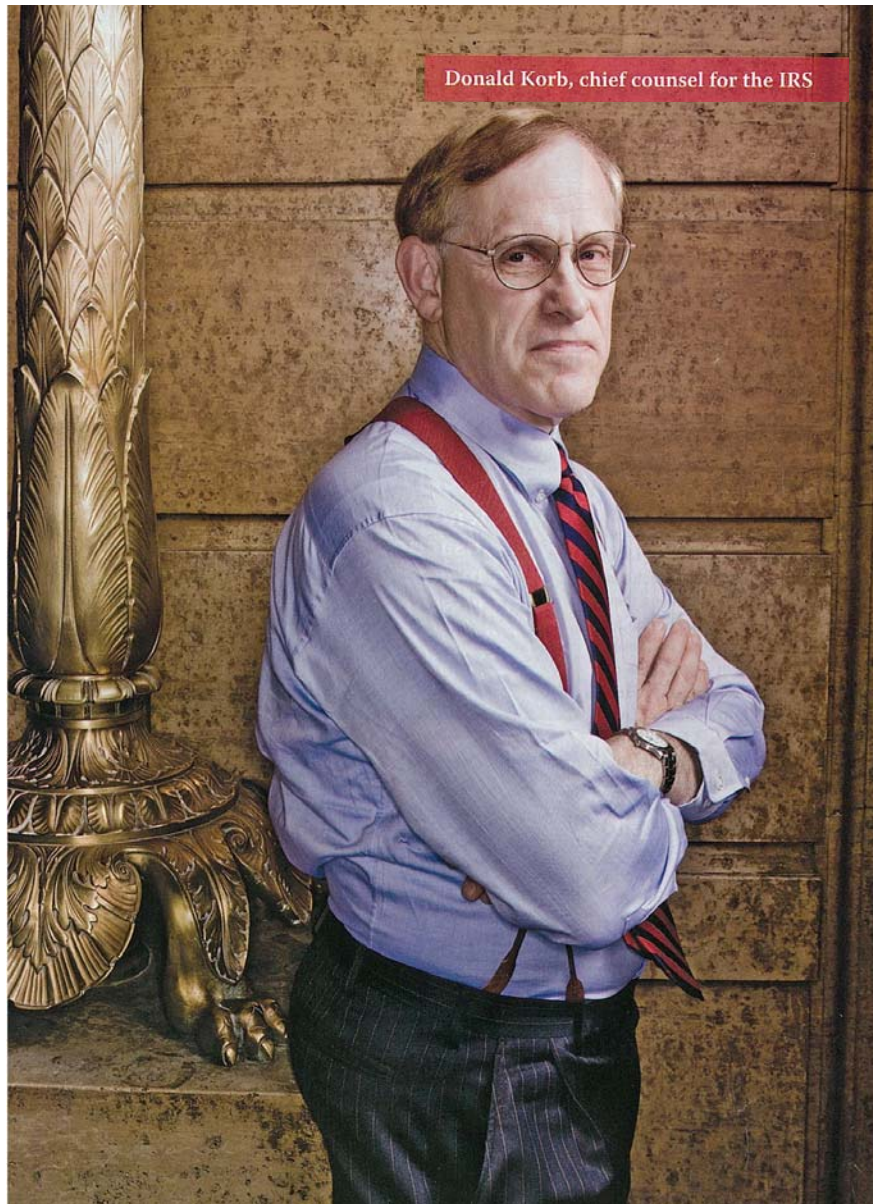
Litigious Environment (“Don’t Mess with the IRS”)

Even companies that aren’t harboring any tax shelters on their books may not be safe. Experts say the IRS’s treatment of all types of tax disputes is changing as the agency applies the tough tactics it used in shelter cases to more ordinary transactions.

This new approach, coupled with an unprecedented amount of new disclosure required from companies, has made the IRS a fundamentally tougher opponent, both in court and out. “The odds are overwhelmingly in our favor,” says Donald Korb, chief counsel for the IRS since 2004.

For his part, Korb says that, in general, the IRS would rather settle than litigate. But to encourage more settlements, the agency is deliberately pushing some companies to trial – refusing to settle for less than 100 percent of taxes owed, plus penalties and interest – in order to make an example of them. The idea is to win a number of cases and thus pressure other companies that made similar transactions to “fold their tents” and pay up, says Korb. “At some point, if the government wins four or five cases, it’s going to be hard to have give-and-take,” he warns.

CFO Magazine, July/August 2008



Commissioner Shulman's Remarks

JCT Recommendations

IRS Commissioner Shulman wants to ensure that taxpayers do not “use the ... tax code complexities to push tax planning beyond acceptable bounds...[that they] pay what they owe.” He announced establishment of a new “Transfer Pricing Practice” within the IRS: a group of experts to coordinate IRS approaches to most important TP issues.

Joint Committee on Taxation staff recommended several changes that would:

- Limit the use of CUTs to exactly comparable uncontrolled transactions and expand the use of the income-based methods;

- Make periodic adjustments under CWI more automatic; and

- Eliminate cost sharing except in very limited circumstances.

Cost Sharing Agreements (“CSAs”) Requirements in Brief

- All participants commit to and engage in cost sharing transactions (“CSTs”)
 - Obligated to share intangible development costs (“IDCs”) in proportion to reasonably anticipated benefits (“RABs”).
- All participants engage in platform contribution transactions (“PCTs”) for any platform contributions
 - Obligated to make arm’s-length payments to each participant that provides a platform contribution (buy-in payments).
- Each participant must receive a non-overlapping interest in the cost-shared intangibles
 - Geographical division of interest
 - Field of use division of interest
 - Other – must be verifiable, non-overlapping, exclusive, and perpetual.
- Each participant must be entitled to the perpetual and exclusive right to profits attributable to that participant’s interest in the cost-shared intangibles.
- The CSA and each participant must satisfy contractual, documentation and other administrative requirements (including filing CSA statements with each tax return).

CSA Ongoing Sharing of IP Development Costs

- Reasonably Anticipated Benefits (RABs)
 - A controlled participant's share of RABs is equal to its RABs divided by the sum of the RABs of all the controlled participants.
 - RAB must be estimated over the “entire” period (past and future) of exploitation of the cost shared intangibles.
- Intangible Development Costs (IDCs)
 - **All** costs in cash or in kind (including stock-based compensation) that are directly identified with, or reasonably allocable to, the IDA (intangible development activity).
 - Cost for land or depreciable property equals the arm's-length rental charge.
 - IDA means the activity under the CSA of developing or attempting to develop reasonably anticipated cost shared intangibles.
 - **Stock-based compensation included in cost pool**
- Cost Sharing Transactions (CSTs)
 - Transactions between CSA participants such that in each taxable year each controlled participant's IDC shares are in proportion to its respective RAB share.
 - Payments made by the controlled participants are referred to as CST Payments.
- Documentation requirements
 - Must meet CSA document requirements as provided in Treas. Regs. §1.482-7T(k)(2).

The *Xilinx* Tax Court Case

- Question: under the “all costs” provision of the regulations, must the “costs” of Employee Stock Options be included in the annual pool of shared costs?
- IRS claimed “Yes,” hence, Ireland should pay part of Xilinx US’s option costs, and to do so is consistent with the Arm’s-Length Standard (ALS).
- Xilinx proved that unrelated parties do not share option costs and the U.S. government does not pay for such costs in any of its cost-plus contracts. Hence it claimed the IRS adjustment violated the ALS.

IRS Reaction to the Tax Court *Xilinx* Decision

IRS Chief Counsel Donald Korb said Oct. 20 the agency is considering whether the opinion limits the government's ability **“to prescribe that certain [transfer pricing] methodologies reach an arm's-length result.”**

Tax Management, *Transfer Pricing Report*, 11/9/05

The 1988 Treasury White Paper Explains CWI Principle and CSAs are Consistent with the ALS

In 1988 Treasury issued the widely cited White Paper (Notice 88-123, 1988-2 C.B. 458), a comprehensive study on section 482 requested by Congress. The study confirmed Congress's intent that the arm's-length standard apply in Cost Sharing Arrangements, even though the "commensurate with income" ("CWI") language was introduced in the Tax Reform Act of 1986.

The White Paper states both that "Congress expected the results produced under a *bona fide* cost sharing arrangement to be consistent with results under the commensurate with income standard," and that "the general goal of the commensurate with income standard is . . . to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible."

9th Circuit *Xilinx* Decision

The U.S. 9th Circuit Court of Appeals (2009) issued a 2-1 opinion, **reversing** the U.S. Tax Court's decision.

All parties and the Court agreed that unrelated parties would not share costs of options.

The Court held that the IRS cannot square its adjustment with the ALS for the “all costs requirement [of §482-7] is *irreconcilable* with the arm’s length standard.” (emphasis added)

Although the IRS vehemently disagreed with this interpretation, the Majority, based on the structure of the regulations and on statutory construction, found that Cost Sharing is “a self-contained regime” (a safe harbor) and is not subject to the ALS.

9th Circuit *Xilinx* Dissent by Judge Noonan

Judge Noonan summed up his disagreements with the Majority's analysis in his dissent by saying that the Court should have held that:

“when the Commissioner talks out of both sides of his mouth, his speech is unintelligible and his regulations are unenforceable.”

Arm's Length by Fiat

It is Arm's Length because the Regulations say it is arm's length:

- The inclusion of equity compensation in the Cost Sharing regulations.
- The periodic adjustments for transferred intangibles.
- The income (investor) model in the buy-in regulations.
- The inclusion of equity compensation in the services regulations.
- The determination of economic substance under 1.482-7T:
“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.”

Authority for Arm's Length by Fiat

Edward Kleinbard, Chief of Staff, Joint Committee on Taxation, commenting on the Tax Court's requiring the IRS to adhere to the arm's-length standard:

“We can simply interpret arm's length to mean what we think it should mean, and if we say it correctly, that's what it means.”

Source: *Tax Analysts*, September 17, 2008 reporting on the September 16, 2008 meeting of the International Tax Institute.