Transfer Pricing

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2016

GETTING THE DEAL THROUGH

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Law Business Research

THE QUEEN'S AWARDS FOR ENTERPRISE: 2012

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3708 4199
Fax: +44 20 7229 6910

First published 2014
Second edition
ISSN 2056-7669

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

CONTENTS

United States

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Overview

1 Identify the principal transfer pricing legislation.

Section 482 of the Internal Revenue Code provides that the Secretary of the Treasury may 'distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among' related organisations, trades or businesses if he or she determines such action is necessary to 'prevent evasion of taxes or clearly to reflect the income of ... organizations, trades or businesses' (IRC section 482). Extensive Treasury Regulations set forth the general principles and guidelines to be followed under section 482, and specific rules for determining the true taxable income of a taxpayer under the arm's-length standard.

Section 6662 of the Internal Revenue Code imposes penalties of up to 40 per cent of the section 482 adjustment. Treasury Regulations promulgated under section 6662 detail the application of penalties to section 482 adjustments, and provide that taxpayers may prepare documentation of their arm's-length pricing analyses to avoid these penalties.

2 Which central government agency has primary responsibility for enforcing the transfer pricing rules?

The Internal Revenue Service (IRS) of the United States Treasury Department.

3 What is the role of the OECD Transfer Pricing Guidelines?

Outside of the context of a mutual agreement procedure (MAP) or a bilateral advance pricing agreement (APA) under an income tax treaty, the IRS administers its own transfer pricing rules under section 482 without reference to the OECD Transfer Pricing Guidelines. In MAP and bilateral APA cases, the IRS does consider the OECD Transfer Pricing Guidelines as a common reference point for negotiating the case with the other government.

The United States was an active participant in the development of the OECD Transfer Pricing Guidelines, and takes the position that its section 482 regulations and the Guidelines are fully consistent.

4 To what types of transactions do the transfer pricing rules apply?

Section 482 applies to any two or more 'organizations, trades, or businesses' that are 'owned or controlled' by the same interests (IRC section 482). The term 'controlled' includes direct or indirect control, whether or not legally enforceable and however exercisable. Commonly controlled taxpayers include parents and their subsidiaries that are ultimately controlled by the same interests as well as brother-sister corporations directly controlled by their parent. Furthermore, the definition encompasses organisations such as commonly controlled trusts, estates, partnerships or other entities. In the case of transactions between entities with less than 100 per cent common ownership, the presence or absence of 'control' is determined by considering all relevant facts and circumstances: 'It is the reality of the control that is decisive, not its form or the mode of its exercise'.

5 Do the relevant transfer pricing authorities adhere to the arm's-length principle?

Yes, the transfer pricing authorities are required to adhere to the arm's-length principle.

Pricing methods

6 What transfer pricing methods are acceptable?

Use of tangible property
No methods are specified. However, the regulations in general provide that an arm's-length charge is the amount that was charged or would have been charged for the use of the same or similar property, during the time it was in use, between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition and all other relevant facts.

Transfers of tangible property
The following transfer pricing methods are acceptable for transfers of tangible property:
- comparable uncontrolled price method;
- resale price method;
- cost plus method;
- comparable profits method (CPM);
- comparable profit split method (CPSM);
- residual profit split method (RPSM); and
- unspecified methods.

Use or transfer of intangible property
The following transfer pricing methods are acceptable for transfers of intangible property:
- comparable uncontrolled transaction (CUT) method;
- CPM;
- CPSM;
- RPSM; and
- unspecified methods.

In addition, section 482 specifically requires that the income with respect to a transfer or licence of intangible property be 'commensurate with the income attributable to the intangible' (IRC section 482).

Services
The following methods are acceptable for services transactions:
- services cost method;
- comparable uncontrolled services price method;
- gross services margin method;
- cost of services plus method;
- CPM;
- CPSM;
- RPSM; and
- unspecified methods.

Loans and advances
No methods are specified. However, the regulations in general provide that an arm's-length interest rate is the rate that was charged or would have been charged between unrelated parties in similar circumstances considering all relevant factors, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower and the interest rate at the situs of the lender for comparable loans.

Safe-haven interest rates are available for certain loans or advances.

7 Are cost-sharing arrangements permitted? Describe the acceptable cost-sharing pricing methods.

Cost-sharing arrangements are permitted. The current section 482 regulations governing cost-sharing arrangements permit the following pricing methods for platform contribution transactions (ie, buy-ins):

- CUT method;
- comparable uncontrolled services price method;
- income method;
- acquisition price method;
- market capitalisation method;
- RPSM; and
- unspecified methods.

Participants must make balancing payments in accordance with the proportional reasonably anticipated benefits (RAB) that each participant will gain under the arrangement. Each participant's RAB share must be determined using 'the most reliable method' (Treas Reg section 1.482–7(e)(1)(ii)).

8 What are the rules for selecting a transfer pricing method?

Section 482 regulations require that the 'best method' be used to determine the arm's-length price in an intercompany transaction. The best method is the method that, under the facts and circumstances, provides the most reliable measure of an arm's-length result.

9 Can a taxpayer make transfer pricing adjustments?

Yes, a taxpayer can make transfer pricing adjustments. A taxpayer may report on a timely filed US income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. However, taxpayers are not permitted file an untimely or amended return to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. A recent US Court of Federal Claims decision, *Intersport Fashions West Inc v US*, 103 Fed Cl 396 (2012), broadly interpreted this prohibition, but related-party agreements that require periodic transfer pricing adjustments may be an effective way to mitigate the impact of this rule.

10 Are special 'safe harbour' methods available for certain types of related-party transactions? What are these methods and what types of transactions do they apply to?

Safe harbours are available for intercompany services and loans. The services cost method, which allows certain low margin services to be charged at cost plus no markup, is available for certain intercompany services that the IRS has specified in a revenue procedure (Revenue Procedure 2007–13) or for which the median comparable markup is less than or equal to 7 per cent, provided certain other requirements are met.

Safe haven interest rates, defined as rates between 100 per cent and 130 per cent of the applicable federal interest rate, can be applied to most intercompany loans or advances. The safe haven rates cannot be applied where the lender is engaged in the business of making loans or where the loan is denominated in a currency other than the US dollar. The applicable federal interest rate is either the short-term, medium-term or long-term rate, depending on the term of the intercompany loan. The IRS publishes these rates in monthly revenue rulings.

Disclosures and documentation

11 Does the tax authority require taxpayers to submit transfer pricing documentation? What are the consequences for failing to submit documentation?

A taxpayer is not specifically required to prepare and submit transfer pricing documentation.

12 Other than complying with mandatory documentation requirements, describe any additional benefits of preparing transfer pricing documentation.

Although transfer pricing documentation is not mandatory, documentation may allow a taxpayer to avoid the imposition of section 6662 transfer pricing penalties.

13 When must a taxpayer prepare and submit transfer pricing documentation to comply with mandatory documentation requirements or obtain additional benefits?

In order to avoid potential section 6662 penalties, the taxpayer must have prepared the documentation by the time it files its tax return. The taxpayer must provide this 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.

14 What content must be included in the transfer pricing documentation? Will the tax authority accept documentation prepared on a global or regional basis or must it conform to local rules? What are the acceptable languages for the transfer pricing documentation?

The documentation must adhere to the US rules and must be prepared in English. It must establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most reliable measure of an arm's-length result under the principles of the best method rule. The following principal documents must be included in the taxpayer's documentation:

- an overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;
- a description of the taxpayer's organisational structure (including an organisation chart) covering all related parties engaged in transactions potentially relevant under section 482;
- a description of the method selected and an explanation of why that method was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met;
- a description of the alternative methods that were considered and an explanation of why they were not selected;
- a description of the controlled transactions (including the terms of sale) and any internal data used to analyse those transactions;
- a description of the comparables that were used, how comparability was evaluated and what (if any) adjustments were made;
- an explanation of the economic analysis and projections relied upon in developing the method;
- a 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 and applied a specified method in a reasonable manner; and
- a general index of the principal and background documents and a description of the record-keeping system used for cataloguing and accessing those documents.

In addition to these principal documents, the taxpayer must also maintain any background documents that support the assumptions, conclusions and positions of the principal documents.

Adjustments and settlement

15 How long does the authority have to review a transfer pricing filing?

Ordinarily, the IRS has three years from the date of the tax return to make a section 482 adjustment with respect to that year. However, the IRS has six years to make an adjustment if the return omits gross income in excess of 25 per cent of the reported gross income. The IRS can make an adjustment at any time related to a false or fraudulent return, if the taxpayer wilfully attempts to evade taxes, or if the taxpayer does not file a return.

16 If the tax authority proposes a transfer pricing adjustment, what initial settlement options are available to the taxpayer?

Initially, the taxpayer may work with the examining agents to demonstrate that the proposed adjustment is an error. If the taxpayer does not persuade the examining agents, then the taxpayer may request that the appeals division independently review the proposed adjustment and consider the likelihood that the examining agents' adjustment will be upheld in judicial review. The IRS also provides several alternative dispute resolution mechanisms.

17 If the tax authority asserts a final transfer pricing adjustment, what options does the taxpayer have to dispute the adjustment?

The taxpayer may seek judicial review of a transfer pricing adjustment in three tribunals. First, the taxpayer may file a petition in the US Tax Court within 90 days of receiving the final notice of deficiency. The taxpayer need not pay the asserted deficiency prior to seeking judicial review in the Tax Court. Second, the taxpayer may pay the additional tax arising from the adjustment and sue the US for a refund in a US district court. Finally, the taxpayer may pay the addition to tax and sue the US for a refund in the Court of Federal Claims.

A taxpayer may also seek relief from double taxation through the US competent authority, in accordance with the procedures described below.

Relief from double taxation

18 Does the country have a comprehensive income tax treaty network? Do these treaties have effective mutual agreement procedures?

The United States has an extensive double tax treaty network, covering its major trading partners in North America, Europe and much of the Asia-Pacific region. Major 'holes' in the United States' treaty network include most of Latin America (most notably Brazil), Singapore and Hong Kong.

For the most part, the mutual agreement procedures under the United States' income tax treaties are very effective. The US competent authority has strong relations with most of its treaty partners. While there had been a well-publicised dispute between the US and Indian competent authorities, treaty relations between the US and India are reported to be gradually normalising following India's appointment of a new competent authority. The two countries have undertaken an initiative to clear a five-year backlog of cases, and in particular have agreed to a framework for resolving cases involving information technology-enabled services (ITeS) and software development.

19 How can a taxpayer request relief from double taxation under the mutual agreement procedure of a tax treaty? Are there published procedures?

A taxpayer may request relief from double taxation under the MAP of an income tax treaty by filing a request with the competent authority pursuant to the procedures set forth in IRS Revenue Procedure 2006-54 (for requests filed before 30 October 2015) or Revenue Procedure 2015-40 (for requests filed on or after 30 October 2015).

20 When may a taxpayer request relief from double taxation?

In the case of an IRS-initiated adjustment, taxpayers generally have the discretion under both Revenue Procedure 2006-54 and Revenue Procedure 2015-40 to request the assistance of the competent authority any time after receiving a notice of proposed adjustment from the IRS that has the potential to result in double taxation. Under Revenue Procedure 2015-40, the IRS no longer permits taxpayers to seek IRS appeals division review of an IRS-initiated adjustment prior to requesting competent authority assistance. A taxpayer that does initiate an appeals division review is generally precluded from later requesting competent authority assistance unless the double tax issue is severed from the issues under consideration by the appeals division within 60 days of the taxpayer's opening conference with appeals. However, the Revenue Procedure provides a 'Simultaneous Appeals Procedure' (SAP) that taxpayers are able to utilise for simultaneous review by the appeals division and competent authority. Competent authority consideration of issues in litigation is also possible, but may require a joint taxpayer–IRS motion to sever, and the consent of the IRS Associate Chief Counsel (International). A US taxpayer can generally request competent authority assistance with respect to a foreign-initiated adjustment any time after receiving a written notice of the proposed adjustment from the foreign governments, provided that the US competent authority receives a treaty notification within the time frame specified in the applicable treaty.

21 Are there limitations on the type of relief that the competent authority will seek, both generally and in specific cases?

Under Revenue Procedure 2006-54 (applicable until 30 October 2015), if a taxpayer requests competent authority assistance after the final resolution of the transfer pricing issue through a closing agreement, an agreed deficiency with the appeals division (Form 870-AD), or a judicial decision, the competent authority will seek only correlative relief. This means that the US competent authority will try to convince the foreign competent authority to allow a deduction in the amount of the US adjustment on a 'take it or leave it' basis, but will not reconsider or compromise the agreed adjustment. Thus, if the US competent authority does not convince its treaty partner in a case thus described to agree completely with the IRS adjustment, the probability for double taxation is very high. In other cases, the competent authority does have authority to compromise the examination division adjustment.

Under Revenue Procedure 2015-40 (applicable beginning 30 October 2015), similar rules apply with one important exception: a taxpayer that executes a Form 870-AD or closing agreement with the appeals division, or that files a protest with appeals and does not request competent authority assistance within 60 days of its opening conference with appeals, is completely precluded from seeking any relief (even correlative relief) from the competent authority. This limitation does not apply to taxpayers that utilise the special SAP procedures for simultaneous consideration of a transfer pricing issue by the appeals division and competent authority.

22 How effective is the competent authority in obtaining relief from double taxation?

The competent authority is generally highly effective in obtaining relief from double taxation for taxpayers. The IRS's 2014 Competent Authority annual report confirms that the overwhelming majority of MAP cases are successfully resolved on a basis that relieves all double taxation. Of the 133 cases concluded in 2014, 125 were resolved on a basis that relieved all double taxation. Of the remaining eight, four were resolved on a basis that provided partial relief from double taxation, two were cases withdrawn by the taxpayer, and only two involved no double tax relief being granted.

Advance pricing agreements

23 Does the country have an advance pricing agreement (APA) programme? Are unilateral, bilateral and multilateral APAs available?

The US established the world's first formal APA programme in 1991. The current programme is called the Advance Pricing and Mutual Agreement (APMA) programme. The APMA programme is the product of a 2012 restructuring that combined the formerly separate APA programme (which negotiated unilateral APAs and developed negotiating positions in bilateral and multilateral cases) and the competent authority office (which negotiated bilateral and multilateral APAs as well as MAP cases with the foreign governments). Unilateral, bilateral and multilateral APAs are all available. However, the APMA programme may require special justification to enter into a unilateral APA covering transactions involving a treaty partner for which a bilateral or multilateral APA would be available.

24 Describe the process for obtaining an APA, including a brief description of the submission requirements and any applicable user fees.

Taxpayers initiate the process for obtaining an APA by filing an APA request with the APMA programme that meets the content requirements of Revenue Procedure 2006-9 (generally applicable for requests filed before 29 December 2015) or Revenue Procedure 2015-41 (generally applicable for requests filed on or after 29 December 2015, or earlier at the election of the taxpayer). Under Revenue Procedure 2006-9, the APA request generally must be filed by the date that the taxpayer files its income tax return for the first taxable year of the APA term. However, a taxpayer can obtain a 120-day extension to file an APA request by paying the applicable user fee (discussed below) by this date. Revenue Procedure 2015-41 adopts a general rule requiring APA requests to be filed within this same time frame, and a new special rule requiring bilateral or multilateral APA requests to be filed within 60 days of the filing date of the APA request with the foreign tax competent authority (if earlier). Among other substantive and procedural requirements, the APA request must include a full functional and factual analysis and proposals for one or more covered transactions, transfer pricing methods (and economic analysis to support such methods), critical assumptions and an APA term. As compared to Revenue Procedure 2006-9, Revenue Procedure 2015-41 requires more extensive and

prescriptive submissions and makes prefiling submissions and conferences mandatory in certain cases. Under Revenue Procedure 2006-9, the user fee for an APA is US$50,000, though special reduced rates of US$35,000 and US$22,500 apply to renewal APAs and certain 'small business' APAs, respectively. Revenue Procedure 2015-41 raises the general user fee to US$60,000 and the 'small business' APA user fee to US$30,000, but retains the reduced US$35,000 user fee for renewal APAs.

25 How long does it typically take to obtain a unilateral and a bilateral APA?

The time required to obtain an APA can vary greatly depending on a number of factors, including the complexity of the transactions and the issues, the workload of the particular APMA staff members assigned to the case and, in bilateral cases, the treaty relationship between the IRS and the particular foreign tax authority assigned. According to statistics released in the IRS's 2014 Announcement and Report Concerning Advance Pricing Agreements (APA Annual Report), the average completion time for APAs concluded in 2014 was 31.3 months for unilateral and 40.0 months for bilateral APAs.

26 How many years can an APA cover prospectively? Are rollbacks available?

The most typical term is five years, but extended terms of six to eight years are relatively common, and terms longer than 10 years have been negotiated. According to the IRS's 2014 APA Annual Report, 41 per cent of APAs concluded in 2014 had a five-year term and over 50 per cent had terms of six years or longer. A small number of completed APAs (less than 10 per cent) had terms of 10 years or longer. Rollbacks are available. Under the existing procedures in Revenue Procedure 2006-9, the examination or appeals divisions formally retained jurisdiction over rollback years and rollbacks were generally implemented through an instrument other than the APA itself (eg, a closing agreement with the examination or appeals divisions). Under Revenue Procedure 2015-41, APMA has jurisdiction over rollbacks (though it will continue to coordinate and collaborate with other IRS offices) and may include rollback years in the APA term.

27 What types of related-party transactions or issues can be covered by APAs?

APAs can cover the transfer pricing of related-party transactions of all sorts, including tangible and intangible property transfers, intercompany services, cost-sharing arrangements and financial transactions, including guarantees and the allocation of income of a financial institution engaged in the global trading of financial instruments. In addition to traditional transfer pricing issues, APAs can also cover issues for which transfer pricing principles may be relevant and ancillary issues such as interest and penalties.

28 Is the APA programme widely used?

APAs are very widely used in the US. According to statistics released in the IRS's 2014 APA Annual Report, the IRS has concluded 1,401 APAs from 1991 to 2014, of which 509 were unilateral, 878 were bilateral and 14 were multilateral. The IRS concluded 145 APAs in 2013 and 101 in 2014. In 2013 and 2014, the IRS received 111 and 108 APA applications, respectively.

29 Is the APA programme independent from the tax authority's examination function? Is it independent from the competent authority staff that handle other double tax cases?

The IRS APMA programme is separate from the examination function. However, as a result of the aforementioned 2012 restructuring, the APMA programme is now a part of the Large Business and International division, which also houses the examination function. The Director of APMA reports to the Director of Transfer Pricing Operations, who also oversees the IRS Transfer Pricing Practice that provides support to transfer pricing examinations. Also as a result of the 2012 restructuring, the same APMA programme staff now handle both APA and double tax cases.

In comparison, prior to the 2012 restructuring, the APA programme was located in the Office of Associate Chief Counsel (International) and was therefore further removed from the examination function. Also prior to 2012, the APA programme, which developed negotiating positions for bilateral APAs and negotiated unilateral APAs with taxpayers, was separate from the competent authority office, which negotiated bilateral APAs and other double tax cases with the other government.

Both before and after the 2012 restructuring, examination function personnel participate as team members in most APA negotiations. Their role in the process can vary depending on the nature of the issues involved, the prior examination history of the taxpayer and the desire of the particular examination team to be engaged in the process, but the examination function does not have a veto power over the APMA team.

30 What are the key advantages and disadvantages to obtaining an APA with the tax authority?

A key advantage of an APA is to obtain certainty with respect to transfer pricing issues that might otherwise give rise to long, protracted disputes with the IRS or one or more foreign tax authorities. As such, APAs can provide a particularly cost-effective solution by providing a high degree of certainty for multiple tax years with foresight. By providing such certainty, APAs have the added advantage of providing financial statement benefits. Another advantage of APAs is the availability of special rollback procedures, through which the agreed transfer pricing methodology of an APA can be applied to resolve unagreed issues involving the same transactions in prior open tax years, including issues already under examination. Moreover, bilateral and multilateral APAs can be particularly advantageous in their ability to resolve transfer pricing issues in both the United States and one or more foreign jurisdictions on a coordinated and prospective basis.

One disadvantage of APAs is that the initial upfront cost of an APA is generally higher than the cost of not seeking an APA and instead preparing transfer pricing documentation. Another disadvantage is that APAs can take a relatively long time to complete (average completion times are over two and a half years for a unilateral APA and over three years for a bilateral APA). A third disadvantage is that filing an APA request may lead the IRS or foreign tax authority to uncover or raise issues that otherwise would not be raised during the context of an examination.

Special topics

31 Is the tax authority generally required to respect the form of related-party transactions as actually structured? In what circumstances can the tax authority disregard or recharacterise related-party transactions?

Under the section 482 regulations, the IRS must respect related-party transactions as actually structured by the taxpayer so long as they have 'economic substance'. Very generally, a related-party transaction will be regarded as having economic substance if the taxpayer's conduct conforms with the terms of the deal that it struck for itself.

The United States Treasury and IRS officials have publicly spoken against proposals for certain 'special measures' under consideration as part of the OECD's base erosion and profit shifting (BEPS) project that would have the effect of making it easier for tax authorities to disregard or recharacterise related-party transactions.

32 What are some of the important factors that the tax authority takes into account in selecting and evaluating comparables? In particular, does the tax authority require the use of country-specific comparable companies, or are comparables from several jurisdictions acceptable?

In selecting comparables, the IRS considers all factors that could affect prices or profits in uncontrolled transactions, including functions, risks, contractual terms, economic conditions and the property or services involved.

When the tested party is a US entity, there is seldom a need to use global or multijurisdictional comparables because a sufficient number of US comparables are available to benchmark almost all functions. This being said, it is typical for US practitioners to use sets of North American comparables that consist mostly of US companies but also include some Canadian companies. Such North American comparables sets are routinely accepted by the IRS. In the case of non-US-tested parties, the IRS often places greater emphasis on functional rather than geographic market comparability.

Update and trends

The IRS has asserted large transfer pricing adjustments against a number of US corporate taxpayers. Several of these cases are docketed in the US Tax Court. Taxpayers including Amazon, Inc and Medtronic, Inc are currently awaiting the Tax Court's decision. Other taxpayers seeking Tax Court review include Eaton Corp, Guidant Corp, and Zimmer Holdings, Inc. Further, Microsoft Corp is suing to compel the IRS to disclose records related to the IRS's retention of the private law firms Quinn, Emanuel, Urquhart & Sullivan LLP and Boies, Schiller & Flexner LLP to assist in the agency's audit of the company's cost-sharing arrangement. Finally, Altera recently succeeded in challenging a section 482 regulation requiring the participants in a cost-sharing arrangement to share employee stock option compensation amounts. These cases reflect the IRS's continued focus on transfers of intangible property to foreign subsidiaries among other transfer pricing matters.

The Treasury Department and the IRS actively participate in the OECD's BEPS Action Plan project. In this connection, Treasury Department officials have publicly spoken out against proposals for certain transfer pricing 'special measures' and other proposals supported by some OECD countries that would make it easier for tax authorities to recharacterise or otherwise apply non-arm's-length principles to certain related-party transactions. However, the Treasury Department has committed to implementing country-by-country reporting requirements for certain companies as contemplated by the BEPS Action Plan. While the Treasury Department believes it can implement country-by-country reporting by regulation and that legislation is not required, some members of the US Congress have questioned whether the Treasury Department has this authority. Thus, the prospect for implementation of country-by-country reporting and potentially other BEPS Action Plan items in the US remains somewhat uncertain.

Notwithstanding this uncertainty, many forward-looking taxpayers are considering the implications of country-by-country reporting and taking a holistic view of their transfer pricing policies and documentation in light of the BEPS Action Plan.

33 What is the tax authority's position and practice with respect to secret comparables? If secret comparables are ever used, what procedures are in place to allow a taxpayer to defend its own transfer pricing position against the tax authority's position based on secret comparables?

The IRS is prohibited from using secret comparables. One reason the IRS has historically resisted the temptation to use secret comparables is that high quality financial data for a vast number of independent companies is publicly available due to the sheer size of the US market and the detailed financial reporting requirements that the Securities and Exchange Commission imposes on all publicly traded companies and certain non-publicly traded companies in the US.

34 Are secondary transfer pricing adjustments required? What form do they take and what are their tax consequences? Are procedures available to obtain relief from the adverse tax consequences of certain secondary adjustments?

Under the US transfer pricing rules, transfer pricing adjustments asserted by the IRS or self-initiated by the taxpayer as permitted by the regulations (referred to as primary transfer pricing adjustments) also give rise to:

- correlative adjustments to the books of any related party affected by the primary adjustment (for example, an adjustment to increase the income of a US licensor will require a correlative adjustment to reduce the income of the non-US licensee for US tax purposes); and
- adjustments to conform the taxpayer's accounts to the primary adjustment (conforming adjustments). Conforming adjustments generally take the form of deemed distributions or capital contributions and are used to explain, for US tax purposes, why more or less consideration was transferred than the arm's-length price. For example, assume that a US subsidiary pays its foreign parent a royalty of US$10 but the IRS subsequently makes a primary transfer pricing adjustment to reduce the royalty to US$8. The conforming adjustment in this case would be a deemed distribution of US$2 paid by the US subsidiary to the foreign parent.

Such deemed distributions and capital contributions are subject to the same tax consequences as actual distributions and capital contributions, including the imposition of withholding on deemed distributions that are treated as dividends.

In lieu of conforming adjustments, taxpayers may instead elect, under Revenue Procedure 99-32, to treat the otherwise required conforming adjustment amount as an interest-bearing account receivable. An election under Revenue Procedure 99-32 avoids the adverse tax consequences of a deemed distribution, but the creation of a deemed account receivable in its place may have other tax consequences.

35 Are any categories of intercompany payments non-deductible?

Generally, the rules governing the deductibility of payments are completely independent from the transfer pricing rules and apply in a non-discriminatory manner to both related-party and unrelated-party payments. As an exception, Internal Revenue Code section 163(j) limits the deductibility of interest on certain related-party debt where no income tax is imposed on the corresponding item of interest income, as well as certain third party debt guaranteed by certain foreign or tax exempt related parties. The amount of disallowed interest expense is limited to the taxpayer's 'excess interest expense' (ie, any interest expense greater than 50 per cent of the taxpayer's adjusted taxable income plus any excess limitation carry forward) for the taxable year. This disallowance only applies when the taxpayer's ratio of debt to equity exceeds 1.5 to one.

36 How are location savings and other location-specific attributes treated under the applicable transfer pricing rules? How are they treated by the tax authority in practice (if different)?

The section 482 regulations explicitly address the issue of location savings in an arm's-length analysis. See Treasury Regulations section 1.482-1(d)(4)(ii)(C). This regulation provides that comparability adjustments may be necessary to account for significant differences in costs attributable to geographic markets, if these differences would affect the consideration in an uncontrolled transaction given the relative competitive position of buyers and sellers in each market. Accordingly, lower total costs in a geographic market will only justify adjustments to the uncontrolled comparables – and correspondingly higher profits to a controlled party – if these lower costs would justify higher profits to comparable uncontrolled parties in that geographic market. In effect, this means that a controlled party should only be allowed to reap the benefits of location savings to the extent that comparable uncontrolled parties would also benefit from these savings.

37 How are profits attributed to a branch or permanent establishment (PE)? Does the tax authority treat the branch or PE as a functionally separate enterprise and apply arm's-length principles? If not, what other approach is applied?

The United States supports the 'authorised OECD approach' for attributing profits to PEs. The authorised OECD approach treats a PE as if it were a 'distinct and separate enterprise', then determines the profits attributable to such PE by applying arm's-length transfer pricing methods by analogy. Notably, the authorised OECD approach requires the recognition and compensation of intracompany transactions (called 'dealings') between a PE and its head office that are identified through a functional analysis.

The authorised OECD approach is incorporated into article 7 of the US Model Income Tax Convention, and into the United States' treaties, treaty protocols or exchange of notes with major trading partners including Canada, Germany, Japan and the UK. However, the authorised OECD approach is not incorporated into many of the United States' older income tax treaties. Where the authorised OECD approach does not apply, the United States applies general arm's-length principles to attribute profits to PEs, but may not recognise intracompany dealings.

38 Are any exit charges imposed on restructurings? How are they determined?

The transfer pricing rules provide no specific guidance on restructurings and no specific exit charges are imposed. However, the United States contributed extensively to the development of Chapter 9 of the OECD Transfer Pricing Guidelines on Restructuring, and therefore, the IRS can be expected to approach restructurings in a manner consistent with Chapter 9. Specifically, the IRS would likely take a nuanced position that while a transfer of mere profit potential in connection with a restructuring is not compensable, arm's-length compensation is required for the transfer of any assets or the termination of any contractual rights that would be compensated by unrelated parties under comparable circumstances.

39 Are temporary special tax exemptions or rate reductions provided through government bodies such as local industrial development boards?

No.

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