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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Companies Face More Pressure To Get Transfer Pricing Right

By **Vidya Kauri**

Law360, New York (July 28, 2016, 5:21 PM ET) -- Amid a changing global tax environment and a seemingly renewed determination by the IRS to litigate transfer pricing disputes, multinational companies wanting to save millions of dollars in audits and legal fees are under heightened pressure to ensure the accuracy of prices for products traded between related legal entities.

With billions of dollars at stake in high-profile cases involving Amazon.com Inc., Altera Corp., Coca-Cola Co. and Microsoft Corp., and the IRS' recent reorganization of its Large Business and International Division, which has resulted in a larger transfer pricing practice, the agency appears to be acting out comments made by its former chief economist that taking more and better cases is preferable to a lengthy, drawn-out effort to revise regulations, according to Larissa Neumann of Fenwick & West LLP.

"The IRS has been aggressively pursuing transfer pricing cases, especially cost-sharing buy-in payments," Neumann said. "The IRS has always had the power to designate a case for litigation, but in the past has rarely done so. [It] seems anxious to try and get good precedent."

The core issue with transfer pricing within a multinational corporation is determining what data, methodology and comparables can and should be used to calculate the arm's-length price for a transaction as it would occur between two unrelated parties, Mayer Brown LLP's Brian Kittle said.

"Determining the arm's-length price of a transaction that will occur between two unrelated parties is replete with judgment calls and various exercises related to due diligence to make the proper determination," Kittle said.

The litigious climate is just one factor for a number of multinational companies' reporting low levels of satisfaction with current approaches to transfer pricing.

A recent Deloitte survey found that businesses are trying to increase the control they have over their transfer pricing positions out of fear of a "high degree of uncertainty" stemming from global tax rules that are in flux and the potential for the inconsistent application of current tax laws.

The Organisation for Economic Co-operation and Development made a slew of recommendations in October to fight what it calls base erosion and profit-shifting, or BEPS, but the group's transfer pricing guidelines, which have begun to be adopted in various countries, differ slightly from the U.S. approach.

While the U.S. remains focused on which entity within a group ultimately owns intellectual property, the

BEPS guidance has shifted toward requiring an entity that funds the development of intellectual property to physically employ people who would be developing, enhancing and protecting that property, Deloitte international tax leader Todd Izzo said.

"We've seen a bit of an erosion of this pure economic ownership concept and a move toward requirement of increased functionality around that intellectual property," Izzo said. "Companies out of necessity had to centralize and clarify the ownership of where that intellectual property should reside."

Although the differences between the OECD's and U.S.' transfer guidelines are not major, they could lead to granular conflicts and disputes involving competent authorities where it may be unclear how to value certain factors, and whether risks outlined in a contract but not ultimately undertaken should be considered while making transfer pricing adjustments, Kittle said.

"It is really important for companies to do significant due diligence upfront," Kittle said. "That due diligence will include identifying functions, risks and other obligations of the parties involved, making sure they reduce those into an agreement and that they then comply with the terms agreed upon."

Such an agreement will serve as a framework for delineating transactions then performing an analysis to determine the appropriate transfer price, he added.

According to Neumann, the IRS has supported the arm's-length standard on the international stage, but on the home front has actually sought to undermine this standard in some of the domestic disputes the agency is confronting.

The IRS has suffered a number of big losses lately, including when the U.S. Tax Court sided with chipmaker Altera Corp. last summer after finding that a 2003 IRS regulation defied reasonable decision-making and failed the arm's-length standard of ensuring that transactions between related entities developing intangible property are comparable to what unrelated entities might negotiate.

The IRS has appealed the decision to the Ninth Circuit, and Neumann said than an ultimate victory for the IRS in this case "could undermine the U.S.' efforts to preserve the arm's-length standard in BEPS."

In June, the Tax Court again squarely rejected the agency’s $1.36 billion tax deficiency calculation in a transfer pricing row with Medtronic Inc. after finding that its calculations for intercompany license royalty rates did not reflect a Puerto Rican subsidiary's contributions to company profits.

And most recently, the IRS reached a $275 million settlement this month with Boston Scientific Corp. agreeing to pay that amount to resolve transfer pricing issues in a $3.5 billion dispute in the Tax Court.

With the IRS expanding the scope of its transfer pricing practice and seemingly determined to take on the cases that BEPS aimed to tackle, Marc Levey of Baker & McKenzie LLP said that the ability of companies to win such cases depends on whether they are prepared to retain "absolute control” over their facts, transfer pricing policies and business strategies.

"Taxpayers are going to know their business and their facts better than the government," Levey said. "You need to have control of that rather than have the IRS come in and play game theory with you and tell you how third parties behave."

--Editing by Katherine Rautenberg and Edrienne Su.