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IRS Inbound Distribution Campaign: Practical Lessons from Experience

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One of the 13 campaigns recently announced by the Internal Revenue Service is transfer pricing for inbound distribution. This article, the second in a series focusing on the campaigns, considers the possible IRS approach and practical issues for taxpayers to consider.

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On January 31, 2017, the Internal Revenue Service ("IRS") Large Business & International ("LB&I") Division formally announced its initial batch of 13 "campaigns" that are expected to be a key focus for LB&I examiners in conducting issue-based examinations (Large Business and International Launches Compliance Campaigns, available at http://src.bna.com/m7D). One of these 13 campaigns, and the focus of this article, is transfer pricing for inbound distribution—U.S. distributors of goods sourced from foreign affiliates.

Time will tell whether the new campaign approach differs meaningfully in practice from earlier initiatives such as "tiered" issues and industry-based teams. IRS statements thus far indicate that the campaign approach will have a greater focus on issue *selection* and *process management* than those prior initiatives, which tended towards centralized control of issue *out-*

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comes (see LB&I 2016 Focus Guide, at 2, available at http://src.bna.com/m7E).

With respect to the inbound distributor campaign, the "treatment stream" will involve issue-based examinations and comprehensive training for revenue agents. The IRS hasn't yet identified or released any specific training materials, but the International Practice Units ("IPUs") that the IRS has created over the past few years provide a rough guide to the issues the agency is focused on. Three of these IPUs—covering selection of the best method, the Resale Price Method ("RPM") and the Comparable Profits Method ("CPM")—have focused on inbound distribution issues.

Regardless of how the details of the campaigns are implemented, what is certain is that the list of 13 campaign topics announced will be front-of-mind for exam teams in the near future. Given that, what can taxpayers expect from an audit focused on inbound distribution, and how can taxpayers best prepare and react?

"Something Extra"

The campaign announcement identifies a concern with U.S. distributors' low profits that are "not commensurate with the functions performed and risks assumed." The cause for this concern seems questionable, since distribution activity is not known for its high profit margins. The U.S. wholesale market is remarkably large and complex, with $5.3 trillion in annual sales (representing 2016 sales by merchant wholesalers, except manufacturers' sales branches and offices, see https://www.census.gov/wholesale/index.html) and 5.9 million workers as of December 2016 (see Bureau of Labor Statistics, Industries at a Glance, "Wholesale Trade: NAICS 42," at https://www.bls.gov/iag/tgs/iag42.htm).

The industry's size, however, does not translate into high profitability: the average distributor's profit margin is extremely thin, at about 2 percent after taxes (see "Wholesale Distribution Industry Data," National Association of Wholesaler-Distributors, 2016 Edition, at http://src.bna.com/m7K), which is caused, at least to some extent, by extreme competition among more than 300,000 firms engaged in distribution (see 2014 SUSB Annual Data Tables by Establishment Industry, U.S. 6-digit NAICS tables, at http://src.bna.com/m7).

Perhaps in recognition that distribution is not *typically* a high margin activity, the IRS will often argue that a U.S. inbound distributor is providing "something extra" that a typical distributor does not, and that this constitutes an uncompensated or undercompensated intangible asset, risk, or embedded service. A common IRS claim we have seen is that the distributor engages in marketing activity beyond what a distributor would offer (see Reg. § 1.482-1(d)(3)(ii)(C) ex. 3). Other possible examples include services such as technical support, post-sale customer support, supply chain management, and regulatory compliance. The IRS may also argue that a distributor bears product liability risk, warranty risk, or the risk of aging inventory and obsolescence. Similar to the position taken in the final BEPS reports, the IRS will often look to both the contractual terms allocating provision of services and allocation of risks and parties' actual behavior (see OECD, BEPS Actions 8–10, Guidance for Applying the Arm's Length Principle, at 1.119 et seq. (2015)).

Intangible property is equally important, and we have seen the IRS attribute high-value intangibles to U.S. distributors. The IRS may argue that a license to a distributor constitutes a full grant of patent rights for the products, such that the distributor effectively holds all the rights of an entrepreneurial licensee and deserved a return attributable to its investment in the license. Additionally, we have seen the IRS argue that U.S. distributors cannot deduct royalties for trademarks and marketing intangibles, because the U.S. distributor itself should be considered the economic owner of these intangibles. Of course, from the taxpayer's perspective, these intangibles are typically owned by a foreign parent that performs substantially all research, development, manufacturing, and marketing activities. In such cases, the IRS has essentially transformed a U.S. distributor into the owner of intangibles related to a company's high-value functions, treating the distributor as though it had quite a bit "extra" going on. This represents the more aggressive end of potential IRS arguments, but it's an example of how a company's U.S. distributor can be cast as the economic owner of a company's crown jewels (with U.S. income to match). (The IRS made similar arguments in the *GlaxoSmithKlineHoldings, Inc.* litigation, filed in 2004 and settled in 2006 for approximately $3.4 billion (including interest). T.C. Docket No. 5750-04.)

The BEPS Actions 8–10 reports may be informative here too, particularly the "DEMPE" approach of looking to which party performs and controls the functions related to the Development, Enhancement, Maintenance, Protection, and Exploitation of intangibles (OECD, BEPS Actions 8-10, Intangibles, at 6.71 (2015)). Consistent with recent practice, the IRS may look for arguments that a U.S. distributor performs or controls such DEMPE functions.

"Something Less"

A related argument arises when the taxpayer has good reason to believe its distributor is doing "something less" than the typical distributor, e.g., because the distributor has a contractual guarantee to recover its operating expenses or a right to return unsold inventory for a refund. In these situations, the IRS may overlook these differences and assert adjustments using typical full-fledged distributors as comparables. (On the flipside, in the outbound context the IRS may affirmatively argue that a distributor is doing "something less" so as to support lower returns.)

As with the "something extra" cases, the potential argument from the IRS is that the distributor should be compensated for more than what is reflected in the taxpayer's transfer pricing analysis. The campaign announcement also notes that the IRS is concerned with distributors that "have incurred losses," and we have occasionally seen the argument that a distributor simply cannot have losses, regardless of the economic conditions that might explain that loss. The IRS National Office has, however, acknowledged in a Chief Counsel Advice in 2009 that characterizing a tested party as a routine distributor "does not preclude an arm's length range that includes negative profitability." CCA 200913056 (March 27, 2009).

Common IRS Arguments: How They Affect the Analysis

The presence of non-routine intangibles, risks, and embedded services may be used to cast doubt on a taxpayer's transfer pricing analysis at several levels, from the high-level choice of a transfer pricing method down to the granular adjustments that are made to data from comparables.

Selection of Transfer Pricing Method

The presence of extra risks, intangibles, and services increases the difficulty of finding appropriate comparable transactions. The more direct a transfer pricing method, the higher the degree of comparability required, i.e., similarity between the products involved and terms of a transaction, similarity in the industry and financial characteristics of benchmark companies, etc. As the IRS's IPU on the RPM for inbound distributors notes, the Comparable Uncontrolled Price method ("CUP") is a more direct method, while the CPM is a less direct method, with the RPM in between (LB&I International Practice Service Transaction Unit, Inbound Resale Price Method Routine Distributor, at 3 (updated January 29, 2016); *see also* LB&I International Practice Service Transaction Unit, Best Method Determination for an Inbound Distributor (updated September 3, 2014)).

With the CPM allowing for most flexibility and ease of application, it is not surprising that the IRS has frequently preferred the CPM across a range of transfer pricing issues even where other methods might have been selected by the taxpayer. The IRS's preference can be seen in the statistics for the Advance Pricing Agreement ("APA") process, where 79 percent of new APAs in 2015 used the CPM. Internal Revenue Service, Announcement and Report Concerning Advance Pricing Agreements, at 11 (March 31, 2016).

Selection of Comparable Transactions or Companies

The "something extra" assertion can also be used to disqualify comparables used by the taxpayer and to argue for higher income in the U.S. entity. The distributor's purported intangibles, services, and risks suggest that the entity is not really a simple distributor, but rather a more entrepreneurial entity. If correct, this suggests that the more appropriate comparables are companies that cover more of the value chain, such as a U.S.-based marketer or other value-adding distributor.

Adjustments and Profit Level Indicator Selection

Even if the IRS doesn't try to disqualify the method or comparable data chosen by the taxpayer, the IRS can argue that further adjustments must be made to the comparable data used by the taxpayer, increasing the distributor's income. When using a method like the CPM, the IRS may also argue that a different profit level indicator ("PLI") should be used as the baseline. The IRS routinely examines all PLIs potentially applicable under the CPM, including return on assets and return on invested capital, which most practitioners would consider poor PLIs for a distribution function. One tool the IRS may employ is the CPM Model employed by the Advance Pricing & Mutual Agreement ("APMA") program. This CPM Model, which is linked to the Compustat database, automatically calculates many potential PLIs (operating margin, return on total costs, Berry ratio, return on assets, and return on invested capital), with and without adjustments. The model applies FIFO and working capital adjustments to sales and COGS, as well as several adjustments to operating expenses, including adjustments for PPE, miscellaneous operating assets, and non-interest bearing liabilities. The CPM Model also calculates several diagnostic ratios, such as advertising expense/sales, R&D expense/sales, and capital expenditures/sales. Given the frequency with which the IRS selects the CPM as the best method, taxpayers may be well advised to analyze these diagnostic ratios and various PLI results.

Taxpayer Counterarguments and Considerations

When confronted with the argument that a distributor is doing something extra, there are many possible responses, but these responses typically fall into two broad types of arguments: (1) the distributor isn't in fact providing the purported extra added value; and (2) the taxpayer's existing transfer pricing analysis already addresses the extra value, if any, appropriately.

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At a more granular level, here are some common issues that arise in audits:

IRS Position	Potential Taxpayer Response
■ The taxpayer's distributor is performing [sales, marketing, customer support, regulatory compliance, etc.] and therefore adjustments to comparables or markups on certain costs are necessary	■ First, consider how best to demonstrate that the distributor isn't performing these functions, or to demonstrate that other affiliates are responsible for these activities ■ Second, consider whether the comparables used by the taxpayer already account for this extra activity; it's not unusual for third-party distributors to perform these additional services at various degrees of intensity ■ Third, consider whether adjustments to the comparables data have adequately addressed any dissimilarity between the tested party and the comparables
■ The APA CPM Model shows taxpayer results under a particular PLI that are out of line with the comparables	■ Consider whether the PLI the IRS has focused on is really the right one on a principled basis. The APA CPM Model presents many ways of looking at data and it's relatively easy for the IRS to focus on the outlier metrics that look most in need of adjustment, even if those particular metrics aren't the most salient
■ The U.S. distributor is incurring certain types of expenses (e.g., marketing, technical support, etc.) and therefore it is entitled to all profits associated with that activity	■ Potential defenses include: (1) The expenses at issue are directly reimbursed; (2) Extraordinary expenses of that type are reimbursed; (3) The expenses are effectively reimbursed because the transfer pricing structure requires the distributor to receive an operating margin within the arm's length range
■ The U.S. market is large and important, therefore the U.S. affiliate must be running the show when it comes to marketing strategy	■ Consider the industry and business behavior: is it an industry where products are introduced in ex-U.S. markets first? Are outside advertising and promotional agencies handling the strategy, and if so, who pays them? ■ Take account of the type of product (some require little or no marketing, such as certain B2B transactions) ■ Consider where the strategy is formulated, and whether the U.S. entity has a leading role in the process
■ The U.S. distributor is operating under a license, therefore it is effectively an entrepreneur/owner in the U.S. territory of the underlying product IP	■ In the *outbound* context, the IRS argument would often be reversed: the foreign licensee is a mere routine distributor, entitled to only modest profits and no return on its investment in the intangible property through the license ■ The license is required under intellectual property law in order to ensure full protection of the intellectual property, but does not give the "licensee" distributor an actual right to independently exploit and profit from the intangible

■ The U.S. distributor *must* earn a return within the interquartile range of the IRS's set of independent distributor comparables, notwithstanding differences in functions, risks, assets, or economic conditions that support this particular distributor earning a lower return or even a loss	■ Demonstrate risks *not* borne by the distributor under its intercompany agreements and that these terms have been followed. For example, if a distributor is not intended to bear inventory risk, it would be helpful to show that unsold inventory can be, and is, returned ■ Consider what adjustments to the comparables data are needed to adequately address any dissimilarity in functions, assets or risks between the tested party and the comparables ■ Demonstrate differences in economic conditions based on *all* facts and circumstances, including specific competitive factors impacting the taxpayer's industry (or niche within its industry) that do not affect the comparables

Advance Pricing Agreements: a Common Solution for Inbound Distributors

Finally, taxpayers facing new exposure to their distribution transfer pricing as a result of the campaign may wish to consider entering into an Advance Pricing Agreement ("APA"). Inbound distribution has long been the most common type of transaction covered by APAs and the APMA Program has a proven track record of successfully concluding dozens of distribution APAs each year on principled terms (Internal Revenue Service, Announcement and Report Concerning Advance Pricing Agreements, at 9 (March 31, 2016) (showing that U.S. distributors accounted for 36 percent of tested parties covered by new APAs in 2015)).

The more controlled forum of the APA process is well-suited to resolving complex distribution transfer pricing issues, for example factual issues regarding whether and to what extent an inbound distributor is contributing "something extra." For U.S. inbound distributors of foreign manufacturers located in treaty jurisdictions, a bilateral APA can be a particularly attractive option, since a bilateral APA provides certainty for both current and future tax years (and past tax years through rollback procedures) that the agreed transfer pricing method will be acceptable to both the IRS *and the treaty partner* so as to eliminate the risk of any double taxation. The inclusion of inbound distribution in the IRS's first round of campaign issues, combined with foreign tax authorities' increased scrutiny of transfer pricing in the post-BEPS enforcement environment, make it even more worthwhile to consider an APA for these transactions.

Conclusion

The inbound distributor campaign is likely to follow the path laid down by decades of examinations and APA negotiations. The IRS has as much experience auditing these types of structures as any other in transfer pricing. This wealth of experience and the easy availability of comparable data may funnel audits into the type of "one-size-fits-all" arguments that became common in earlier IRS issue-based initiatives. From the taxpayer's perspective, it's important to take stock of the ways in which its particular facts might differ from the IRS's proposed argument; whether those facts explain why a distributor isn't providing "something extra," or why a distributor is indeed doing "something less" than the comparables the IRS favors.

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