Transfer Pricing

Contributing editor
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GETTING THE DEAL THROUGH

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Transfer Pricing 2019

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Fifth edition

Getting the Deal Through is delighted to publish the fifth edition of *Transfer Pricing*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our new coverage this year includes Korea.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Jason M Osborn of Mayer Brown LLP, for his continued assistance with this volume.

GETTING THE
DEAL THROUGH

London
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United States

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Mayer Brown LLP

Overview

1 Identify the principal transfer pricing legislation.

Section 482 of the Internal Revenue Code (IRC) provides that the United States 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'. Extensive Treasury Regulations set forth the general principles and guidelines to be followed under section 482.

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 is responsible for enforcing all federal tax laws, including transfer pricing rules. Within the IRS, the Treaty and Transfer Pricing Operations Practice Area of the Large Business and International (LB&I) Division has primary responsibility for transfer pricing matters.

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 IRC section 482, without reference to the OECD Transfer Pricing Guidelines. However, 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. 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.

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

IRC section 482 applies to any two or more 'organizations, trades, or businesses' that are 'owned or controlled' by the same interests. The term 'controlled' includes direct or indirect control, whether or not legally enforceable and however exercisable. 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 rules adhere to the arm's-length principle?

Yes.

6 How has the OECD's project on base erosion and profit shifting (BEPS) affected the applicable transfer pricing rules?

The United States has not directly adopted the guidance in the OECD's final report on BEPS Actions 8–10, Aligning Transfer Pricing Outcomes with Value Creation, which among other changes, would require that a related party 'control' any risk that it assumes under a contract and places significantly greater emphasis on the performance of functions in determining the arm's-length allocation of income from controlled transactions. However, the US Treasury Department believes its existing transfer pricing regulations under IRC section 482 are already consistent with the principles of BEPS Actions 8–10.

Pricing methods

7 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 between unrelated parties under similar circumstances.

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, IRC 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'.

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.

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

Cost-sharing arrangements (CSAs) are permitted. The IRC section 482 regulations permit the following pricing methods for platform contribution transactions (formerly referred to as buy-ins) in connection with CSAs:

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

Participants must make balancing payments proportional to the 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'.

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

IRC 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.

10 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, under the IRC section 482 regulations, taxpayers are not permitted to file an untimely or amended return to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. A US Court of Federal Claims decision, *Intersport Fashions West Inc v US*, 103 Fed Cl 396 (2012), interpreted this prohibition strictly, but related-party agreements that require periodic transfer pricing adjustments may be an effective way to mitigate the impact of this rule.

11 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

12 Does the tax authority require taxpayers to submit transfer pricing documentation? Regardless of whether transfer pricing documentation is required, does preparing documentation confer any other benefits?

Transfer pricing documentation is not mandatory, but the failure to maintain contemporaneous documentation could result in the imposition of IRC section 6662 transfer pricing penalties on any underpayment of tax attributable to a transfer pricing adjustment. Transfer pricing documentation also provides taxpayers an opportunity to explain and affirmatively advocate their transfer pricing methodologies to the IRS and other tax authorities. In many cases, robust, persuasive transfer pricing documentation can help narrowly focus a transfer pricing audit, or even convince a tax authority not to conduct such an audit.

The documentation must adhere to the US rules and must be prepared in English. It must contain certain 'principal documents' and 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, set forth under the IRC section 482 regulations. In addition to the principal documents, to avoid penalties the taxpayer must also maintain any background documents that support the assumptions, conclusions and positions of the principal documents.

US taxpayers are not specifically required to maintain a 'master file' or 'local file', although the required 'principal documents' are similar to the local file requirement.

13 Has the tax authority proposed or adopted country-by-country reporting? What are the differences between the local country-by-country reporting rules and the consensus framework of BEPS Action 13?

The US Treasury Department issued final regulations implementing country-by-country reporting (CbCR) requirements for certain US parent companies of multinational enterprises with annual revenue of $850 million or more. The final regulations are generally consistent with the consensus framework of BEPS Action 13. However, the US rules require that the country-by-country reports be filed by the due date (including extensions) of the taxpayer's federal income tax return (generally 15 October for calendar year taxpayers), rather than the 31 December (of the following year) deadline contemplated by Action 13.

14 When must a taxpayer prepare and submit transfer pricing documentation?

Taxpayers must have prepared transfer pricing documentation by the time its tax return is filed to avoid potential IRC section 6662 penalties. Taxpayers must provide this documentation to the IRS within 30 days of a request.

15 What are the consequences for failing to submit documentation?

Taxpayers that fail to submit transfer pricing documentation are subject to IRC section 6662 penalties.

Adjustments and settlement

16 How long does the tax authority have to review an income tax return?

The IRS generally has three years from the date the tax return is filed to make an IRC 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 if a taxpayer does not file a return or wilfully attempts to evade taxes by filing a fraudulent return.

17 If the tax authority asserts a 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 additional 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 bilateral double tax treaty network with a number of countries, 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. The US competent authority generally has strong relations with its treaty partners. Thus, as explained further below, the MAPs under the United States' income tax treaties are typically very effective.

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 2015-40.

20 When may a taxpayer request assistance from the competent authority?

In the case of an IRS-initiated adjustment, taxpayers generally have the discretion under Revenue Procedure 2015-40 to request the assistance of the competent authority any time after receiving a notice of proposed adjustment from the IRS. A taxpayer that initiates 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 requires 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 action any time after receiving a written notice of the proposed adjustment from the foreign governments or earlier if the taxpayer believes the foreign tax authority's action is likely to give rise to double taxation, 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 2015-40, if a taxpayer requests competent authority assistance after the final resolution of the transfer pricing issue with the IRS examination team through a closing agreement, Form 870-AD, or other similar agreement, the competent authority will seek only correlative relief. Similarly, if a taxpayer requests competent authority assistance following a judicial determination of its tax liability (including litigation settlements), the competent authority will only seek 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.

In contrast, if a taxpayer executes a closing agreement or Form 870-AD with the appeals division, or files a protest with appeals and does not request competent authority assistance within 60 days of its opening conference with appeals, the taxpayer 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 discussed above.

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. For example, of the 185 MAP cases concluded in 2016, 65 per cent of cases were resolved through an agreement that fully eliminated double taxation, while another 14 per cent were resolved through unilateral relief. The remaining 21 per cent of cases were either withdrawn by the taxpayer, resolved through a domestic remedy, or resulted in partial relief or some other outcome.

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. 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 2015-41. 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. Bilateral and multilateral APA requests must be filed within 60 days of the filing date of the APA request with the foreign tax competent authority. 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. The user fee for an APA was US$60,000 through 30 June 2018 but increased to US$86,500 effective 1 July 2018 and is set to further increase to US$113,500 effective 1 January 2019. Special reduced rates apply to renewal APAs and certain 'small business' 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 2017 Announcement and Report Concerning Advance Pricing Agreements (APA Annual Report), the average completion time for APAs concluded in 2017 was 32.6 months for unilateral and 41.5 months for bilateral APAs.

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

The most typical term is five years, but longer terms are relatively common. According to the IRS's 2017 APA Annual Report, about 35 per cent of APAs concluded in 2017 had a five-year term, 60 per cent had terms of six years or longer, and 15 per cent had terms of 10 years or longer. Rollbacks are available and APMA has jurisdiction to include rollback years in the APA term (though it will coordinate with other IRS offices in evaluating proposed rollbacks).

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, CSAs 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 certain other tax 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 2017 APA Annual Report, the IRS has concluded 1,713 APAs from 1991 to 2017, of which 590 were unilateral, 1,108 were bilateral and 15 were multilateral. The IRS concluded 86 APAs in 2016

Update and trends

On 22 December 2017, President Donald Trump signed the Tax Cuts and Jobs Act (the Tax Act) into law, fundamentally changing the US international tax system. Many changes significantly alter transfer pricing incentives, while other changes directly amend the transfer pricing rules. First, the corporate tax rate has been permanently reduced from 35 per cent to 21 per cent effective for tax years beginning after 31 December 2017. Second, the Tax Act transitions the US from a 'worldwide' tax system to a modified territorial tax system through a 'participation exemption' that allows a 100 per cent deduction for dividends received from certain foreign subsidiaries. The participation exemption is available to domestic corporations that own 10 per cent or more of a foreign subsidiary. In connection with the transition to a modified territorial tax system, the Tax Act also imposed a one-time deemed repatriation tax on all non-previously taxed post-1986 earnings of foreign subsidiaries. The deemed repatriation tax applies at an effective rate of 15.5 per cent for cash and 8 per cent for non-cash earnings.

The Tax Act also introduced several new technical rules that alter transfer pricing incentives. The first is a tax on global intangibles low-taxed income (GILTI), which generally applies an effective shareholder-level 10.5 per cent tax (calculated as the regular 21 per cent corporate tax rate net of a 50 per cent deduction) on most income of controlled foreign corporations (CFCs) in excess of a 10 per cent routine return on the CFCs' adjusted bases in its tangible assets. This tax applies regardless of whether the CFC income is actually attributable to intangibles. Domestic corporations may claim a credit for 80 per cent of the foreign taxes paid that are attributable to GILTI.

On the flipside, the Tax Act also provides a deduction for foreign derived intangible income (FDII). The FDII regime allows domestic corporations to deduct 37.5 per cent of certain income in excess of a 10 per cent routine return on the domestic corporation's adjusted basis in tangible assets, resulting in an effective tax rate of 13.125 per cent. To qualify, the income generally must be attributable to sales, services and leases of property to foreign unrelated parties for foreign consumption.

Third, the Tax Act introduces a minimum tax regime, referred to as the base erosion and anti-abuse tax (BEAT). The BEAT is a new 10 per cent tax (5 per cent in 2018, 12.5 per cent after 2025) on a modified taxable base that adds back deductions for payments to foreign related parties (base erosion payments). Base erosion payments generally include interest and certain service fees and deductible royalties, but generally do not include (among other exceptions) amounts included in cost of goods sold and charges for services costs with no markup under the 'services cost method' (discussed above under question 11) with certain modifications. The BEAT is owed if it exceeds the corporation's regular tax liability. The BEAT only affects large corporations that have average annual gross receipts of at least US$500 million for the three years preceding the year at issue and that have a ratio of base erosion payments to total deductions of at least 3 per cent.

Further, the Tax Act makes three direct changes to the transfer pricing regime. First, section 936(h)(3)(B) is amended to include goodwill, going concern value, and workforce in place in the definition of an 'intangible asset' for purposes of section 367(d) and 482. Second, sections 482 and 367(d)(2) were amended to allow the IRS to value intellectual property on an aggregated basis or by comparison to realistic alternatives. And third, the Tax Act repeals the longstanding exception to gain recognition under section 367(a) for transfers to a foreign corporation of property that is used in the active conduct of a trade or business outside the United States.

There are a number of high-profile transfer pricing cases being litigated in the Tax Court. Notably, the Coca-Cola Company recently concluded a six-week trial to determine the proper amount of certain arm's-length royalties payable by foreign licensees. Other cases with transfer pricing issues in the Tax Court include *Facebook Inc, 3M Co, Zimmer Biomet Holdings Inc*, and *Thomas & Betts Corp*. Moreover, the IRS has appealed three recent losses in the Tax Court. First, the IRS appealed Altera Corp's successful challenge to a section 482 cost-sharing regulation. Second, the IRS appealed the *Medtronic Inc* decision, where the Tax Court rejected the IRS's comparable profits method for valuing the sale of medical devices in favour of Medtronic's transaction-based approach. And third, the IRS recently appealed the Tax Court's decision in favour of Amazon Inc's transaction-based approach for valuing a cost-sharing buy-in payment.

Finally, the IRS recently issued administrative guidance updating the transfer pricing examination process and replacing its prior transfer pricing roadmap. The guidance provides best practices and processes to assist with the planning, execution and resolution of transfer pricing examinations consistent with the LB&I examination process. The IRS has explained that the guidance is not a set of required steps or a 'one-size fits all tool'.

and 116 in 2017. In 2016 and 2017, the IRS received 98 and 101 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 operationally independent from the examination function, but since 2012, has been part of the LB&I Division with the same ultimate reporting lines as examination. Specifically, the Director of APMA reports to the LB&I Director of Treaty & Transfer Pricing Operations, who also oversees the IRS Transfer Pricing Practice that provides support to transfer pricing examinations.

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?

There are many advantages to obtaining an APA. APAs provide certainty for transfer pricing issues that might otherwise give rise to long, protracted disputes with the IRS or one or more foreign tax authorities. This benefit is only expected to become more invaluable in the future in light of the uncertainty presented by the OECD's BEPS Action Plan. 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 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.

There are also disadvantages to consider. First, the initial upfront cost is generally higher than the cost of not seeking an APA and instead preparing transfer pricing documentation. Second, APAs can take a relatively long time to complete (average completion times are over two years for a unilateral APA and over three years for a bilateral APA). Third, 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 IRC section 482 regulations, the IRS must respect related-party transactions as actually structured by the taxpayer so long as they have 'economic substance'. 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. In addition, 'managerial or operational control' and 'financial capacity' are relevant factors considered in determining whether a related-party assumption of risk has economic substance but, unlike the BEPS Actions 8–10 revisions to the OECD Transfer Pricing Guidelines, are not hard and fast requirements that must be satisfied for an assumption of risk to be respected.

Similarly, taxpayers are generally afforded flexibility in structuring related-party investments as debt or equity, subject to certain limitations. Judicial authorities under IRC section 385 have long recognised the ability of the IRS to recharacterise debt as equity in limited cases based on a multi-factor facts and circumstances analysis. Further, new regulations issued under section 385 in 2016 provide for automatic recharacterisation of debt issued in or that fund certain 'tainted' transactions as equity and require taxpayers to maintain certain documentation to avoid recharactisation in other cases. However, the future of these regulations is uncertain. On 2 October 2017, Treasury issued a report critiquing several aspects of the section 385 regulations, but also explaining that any final decision on whether to revoke or modify the regulations would be postponed until after the enactment of broader tax reform. As explained below, The Tax Cuts and Jobs Act (the Tax Act) was enacted in December 2017, but no final decision has been made on the section 385 regulations.

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 multi-jurisdictional 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 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.

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.

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, IRC section 163(j) limits the deductibility of interest expense based on certain thresholds. 'Old' section 163(j), which was effective until 31 December 2017, generally disallowed related-party 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 applied when the taxpayer's ratio of debt to equity exceeded 1.5 to one. 'New' section 163(j), enacted as part of the Tax Act, generally disallows both related and unrelated party interest expense greater than the sum of business interest income and 30 per cent of adjusted taxable income (for 2018 through 2021) or EBITDA (after 2021).

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?

The IRC section 482 regulations explicitly address the issue of location savings in an arm's-length analysis. The regulations provide 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.

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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. 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 countries such as Canada, Germany, Japan and the UK, but is not incorporated in many older 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 specifically recognise intracompany transactions or '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.

Getting the Deal Through

Acquisition Finance
Advertising & Marketing
Agribusiness
Air Transport
Anti-Corruption Regulation
Anti-Money Laundering
Appeals
Arbitration
Art Law
Asset Recovery
Automotive
Aviation Finance & Leasing
Aviation Liability
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