PERSPECTIVES

THE TAX MAN COMETH – IRS EXPANSION OF SECTION 482 TRANSFER PRICING ENFORCEMENT TO MIDDLE-MARKET COMPANIES

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In the past, transfer pricing cases have typically been large transactions involving large corporations – often the sales of goods and services between US companies and their foreign affiliates. But the landscape of transfer pricing cases is changing. The globalisation of the world economies has substantially increased the number and size of the companies engaged in cross-border transactions, making transfer pricing much more relevant to all corporations and their professionals.

In the past couple of years, the IRS has been shifting more resources to training specialised transfer pricing examiners and teaching examiners to recognise controlled transactions that may present a transfer pricing issue. The Large Business & International (LB&I) division of the IRS has established a team of transfer pricing specialists,

who released a Transfer Pricing Audit Roadmap in 2014 that was designed to provide examiners with audit techniques to assist with transfer pricing examinations.

With the increased scrutiny by the IRS, now is the time for all corporations that engage in transactions with foreign controlled entities to make sure they have a transfer pricing policy and supporting documentation in place to ensure that the transfer prices are set at arm's length.

What is transfer pricing?

Transfer pricing refers generally to the setting of prices for property and services sold between controlled entities, such as a parent corporation selling goods to a subsidiary. Where those corporations are in different tax rate jurisdictions,

the IRS wants to ensure that the income associated with such transactions reflects the economic reality of the transaction.

Section 482 of the Internal Revenue Code is designed to prevent income-shifting through controlled transactions, by allowing the IRS to adjust the amount charged in related-party transactions (where two or more businesses are owned or controlled directly or indirectly by the same interests), for purposes of determining a related party's taxable income if the amount charged is determined to not be 'arm's length'. Under the regulations, a transaction meets the arm's length standard if "the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances". The regulations set forth extensive guidelines on the methods to be used to determine the arm's length range for a transaction, in order to place "a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer".

Transfer pricing examinations

The Audit Roadmap sets forth a two-year timeline for transfer pricing examinations, including the initial planning stage. The roadmap places great emphasis on the planning stage, during which examiners will review a taxpayer's tax and information returns to identify controlled transactions and to compute financial ratios that the examiner will use to help determine potential non-arm's length transfer pricing issues. Examiners will also research the background,

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history, and core business operations of the taxpayer, to try and gain an understanding of the relationship between the taxpayer and its foreign affiliates and the role each entity plays in carrying out the group's activities.

The IRS advises examiners that transfer pricing cases are usually won and lost on the facts. Examiners are advised to put together a compelling story of what drives the taxpayer's financial success, based on a thorough analysis of functions, assets and risks, and an accurate understanding of the relevant financial information. If indications are that the tax result claimed by the taxpayer is at odds with

common sense and economic reality – 'too good to be true' – the IRS recommends further scrutiny. If instead the examiner finds the taxpayer's financial results to be reasonable in light of all of the facts, that may cause the IRS to choose not to pursue the issue.

Potential penalties

If a transfer pricing examination results in an adjustment, the adjustment may be subject to a substantial (or gross) valuation misstatement. A 20 percent substantial valuation misstatement penalty is triggered in transfer pricing cases in two situations: (i) where the price for any property or services subject to Section 482 is 200 percent or more (or 50 percent or less) of the arm's length amount; or (ii) if the net Section 482 transfer price adjustment exceeds the lesser of $5m or 10 percent of the taxpayer's gross receipts. While the reasonable cause exception under Section 6664(c) generally applies to substantial valuation misstatement penalties, it does not apply to the second situation – a penalty triggered by a net Section 482 transfer price adjustment. Instead, the penalty can be avoided only if certain documentation requirements are satisfied.

To avoid a substantial valuation misstatement penalty triggered by a net Section 482 transfer price adjustment, three conditions must be satisfied: (i) the taxpayer determined the price in accordance with a specific pricing method allowed under the regulations and use of that method was reasonable (or, the taxpayer used another pricing method that was likely to result in a price that would clearly reflect income, if the pricing methods in the regulation would not be reasonable); (ii) the taxpayer has documentation that was in existence at the time of filing the return setting forth the determination of the price and establishing that the use of the method was reasonable; and (iii) the taxpayer provides such documentation to the IRS within 30 days of a request – which will happen at the outset of each transfer pricing audit.

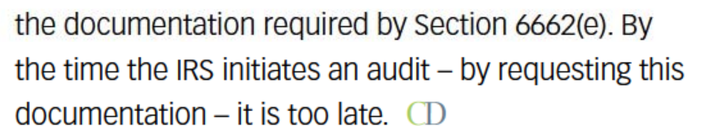
Developing a transfer pricing policy

Obtaining a transfer pricing study with contemporaneous documentation is critical to avoiding penalties and may help to avoid a lengthy audit. The documentation should accurately and completely describe the basic transfer pricing analysis that was conducted and must include: (i) an overview of the taxpayer's business; (ii) a description of the taxpayer's organisational structure covering all related parties engaged in controlled transactions; (iii) an explanation of the transfer pricing methods considered and how the method chosen was selected; (iv) a description of the controlled transactions; (v) an explanation of the comparables used and how comparability was evaluated; (vi) an explanation of the economic analysis and projections; (vii) a description of any relevant data obtained between the end of the year and the filing

of the tax return; and (viii) a general index of the documents.

Conclusion

While the Audit Roadmap was developed by the IRS for use by examiners, it is relevant to all taxpayers with transactions with controlled affiliates, because we know where the roadmap will lead – and that is to more examination activity of more and more taxpayers, not just large companies. The best way for taxpayers to prepare for a transfer pricing audit is before the taxpayer's return is filed and ideally before the transactions are even entered into – by obtaining a transfer pricing study that determines an arm's length price and maintaining


the documentation required by Section 6662(e). By the time the IRS initiates an audit – by requesting this documentation – it is too late. CD

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