OVERVIEW OF U.S. TRANSFER PRICING REGULATIONS

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Recent campaign-based approaches targeting transfer pricing enforcement by the IRS and new transfer pricing documentation standards issued by the Organisation for Economic Co-Operation and Development as part of its base erosion and profit shifting initiative, combined with increased enforcement by the major trading partners of the U.S., have placed increased emphasis on transfer pricing documentation requirements affecting multinational corporations that engage in cross-border transactions with their related parties. Intercompany activity, which is subject to the U.S. transfer pricing rules, includes: sale of tangible goods (finished goods, work-in-progress and raw materials), intangible property (know-how, patents, technology, trademarks, customer lists, etc.), services (management, research and development, marketing, etc.) and financing (loans, guarantees, etc.).

This document primarily covers the U.S. transfer pricing rules under Internal Revenue Code (IRC) §482 and the Treasury regulations thereunder. It also provides some brief guidance on additional countries with transfer pricing requirements, which are similar to those of the United States. The relevant sections of the IRC require that U.S. taxpayers create and maintain contemporaneous transfer pricing documentation on an annual basis. The documentation must exist before the filing of the taxpayer's annual federal income tax return so as to attest the accuracy of the tax return. The contemporaneous documentation requirement applies to all forms of related-party intercompany transactions previously described.

Issues relating to intercompany transactions have become significant in recent years due to the greater attention the IRS has placed on IRC transfer pricing regulations as well as penalty regulations applicable to transfer pricing that require the taxpayer to make a reasonable effort to establish the arm's-length nature of its intercompany pricing policies. The IRS has hired—and plans to hire—a significant number of economists and related specialists to enforce the transfer pricing rules. The following is a brief summary of the regulatory requirements U.S. taxpayers must successfully address to avoid the penalties Congress has authorized to curb potential transfer pricing valuation misstatements associated with international transactions.

For purposes of avoiding nondeductible pricing accuracy related penalties of 20 percent to 40 percent of additional tax payable resulting from a transfer pricing misstatement, and to effectively defend its transfer prices in the event of an IRS audit, a taxpayer's documentation must select and apply a transfer pricing method contained in the regulations by which its transfer pricing activities are to be examined or must explain why a method not specified in these regulations was selected. The documentation also must analyze all of the other possible methods available in the regulations and describe why they were not applicable to the intercompany transaction at issue. More importantly, the taxpayer must provide verifiable arm's-length evidence of its transfer prices based upon comparable transactions that meet the various comparability standards under the transfer pricing regulations. The regulations further provide that taxpayers must present the required contemporaneous documentation to the IRS within 30 days of a request. The documentation is mandated by the IRS to be requested at the opening conference of any IRS audit. Field agents are no longer able to assess the relative merits of the documentation, as this must be performed by IRS international agents or economists.

REQUIRED DOCUMENTATION

The penalty regulations mandate maintenance of several types of voluminous documentation (classified as either principal or background documentation), including:

- An overview of the taxpayer's business, including an analysis of business, economic, legal and other factors that affect intercompany pricing, *i.e.*, the functional and industry analysis.
- A description of the taxpayer's organizational structure (including a chart) covering all related parties engaged in transactions potentially relevant under the transfer pricing rules.
- Any documentation required by the regulations.
- An identification of the transfer pricing methodology determined to be the best method for transfer pricing purposes, together with an explanation of why that method was selected.
- A description of the other transfer pricing methods considered during the best-method selection process and a detailed explanation of why they were not chosen.
- A description of the controlled transactions and any internal data used to analyze those transactions.
- A description of the comparables, how comparability was evaluated and what (if any) adjustments were made to them.
- An explanation of the economic analysis and projections relied on in developing the selected method.

The following additional principal documents also must be maintained by a taxpayer and must be turned over to the IRS within the 30-day period, but do not have to exist at the time the relevant tax return is filed:

- A description of any relevant data the taxpayer obtains after the end of the tax year and before filing a tax return, which would be useful in determining whether the taxpayer's selection and application of its transfer pricing method was reasonable.
- A general index of the principal and background documents related to its transfer pricing analysis and a description of the record-keeping system used for cataloging and accessing these documents.

The required background documentation includes anything necessary to support the principal documents, including, but not limited to, documents identified in the §6038A Treasury regulations.

PENALTIES

Transfer pricing penalties can range from 20 percent to 40 percent of the additional tax owed. In addition, numerous potential penalties exist for a failure to provide required annual information as it relates to controlled foreign corporations and Forms 5471 and 5472 information. A combination of progressively increasing fixed-dollar penalties can be assessed, coupled with a reduction of otherwise allowable foreign tax credits. In addition to these civil penalties, criminal penalties can potentially result.

After August 5, 1997, the penalty for the initial failure to file the appropriate information with the tax return (Forms 5471 and 5472), and the penalty for each continuing 30-day failure beginning 90 days after the notice of failure has been given, increased to $10,000. The maximum total penalty for continuing failures increased to $50,000. However, the monetary penalties are calculated on an entity-by-entity and per occurrence basis.

The statute of limitations for transfer pricing adjustments can run as long as six years after the later of the date the return is filed or the return's due date if a substantial omission has occurred. For income tax purposes, the six-year statute of limitations can be applicable if the taxpayer omits from gross income an amount exceeding 25 percent of the gross income shown on the return.

Related-party intercompany transactions that a taxpayer has not contemporaneously documented for past years creates significant exposure for that taxpayer, as the IRS has been actively levying penalties for failure to have contemporaneous documentation. For this reason, BKD

recommends documenting all intercompany related-party transactions that have not been contemporaneously documented with the filing of annual tax returns.

FOREIGN TRANSFER PRICING REQUIREMENTS

In addition to the U.S., most countries have transfer pricing rules and penalties. Often, these countries have penalties more severe than those of the United States.

OBJECTIVES & SOLUTIONS

The primary objective of a transfer pricing review is to meet contemporaneous documentation requirements and avoid possible penalties in all relevant tax jurisdictions. However, more importantly, a transfer pricing review often leads to new policies that may reduce global taxation and/or reduce the risk of double taxation. That is, in the event a transfer pricing adjustment is sustained on examination, obtaining a correlative adjustment can be very difficult. Consequently, the risk of double taxation is significant. BKD's international tax advisors help clients:

- Develop tax-efficient transfer pricing methodologies to potentially reduce the overall effective tax rate
- Reduce the tax risks associated with transfer pricing
- Develop flexible instruments to achieve cross-border financing
- Take advantage of opportunities to spread capital project costs between international group members
- Achieve compliance without disrupting day-to-day operations
- Obtain advance clearances on pricing (in countries where this is available)

In the event tax authorities initiate a transfer pricing examination, BKD can advise on the conduct of the investigation and help negotiate with examiners.

We provide cost-effective, commercial taxation advice based on a thorough understanding of our client's businesses. In addition, our membership in Praxity, AISBL provides us with access to transfer pricing practitioners through the world and enables us to coordinate advice on a worldwide basis.

The content of this update is written by qualified, experienced BKD client service professionals. However, to apply specific information to your situation requires careful consideration of all the facts and circumstances. Consult your BKD advisor before acting on any matter covered in this update.

FOR MORE INFORMATION // For a complete list of our offices and subsidiaries, visit **bkd.com** or contact:

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