pricing is defined as "the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization."[2]

With the rise of multinational corporations, the tax law needed a mechanism to "clearly reflect income"[3] attributable to controlled entities under different national jurisdictions to prevent tax avoidance and double taxation. To this end, tax authorities have adopted the transfer pricing concept to ensure that taxpayers are taxable on the true taxable income in each tax jurisdiction. Consequently, transfer pricing is a normatively neutral concept, not to be identified per se with either tax avoidance or tax shelters. Indeed, paragraph 3 of the Preface of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises specifically states: "the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes."[4]

¶ 115 Why is Transfer Pricing Important?

Transfer pricing affects numerous points in a multinational enterprise's ("MNE's") financial statements. Table 1 below illustrates the impact of intercompany transfer pricing on financial statements.

Table 1 — Intercompany Transactions in Financial Statements

Income Statement
Revenues • Sales of tangible property: raw materials, finished goods • Services fees: technical, payroll, legal, tax, insurance, training, marketing and sales, R&D, management • Rents: lease of tangible and real property • Royalties for intangible property: licenses of patents, trademarks, and know-how
Cost of sales • Purchases of tangible property: raw materials, work-in-progress, finished goods • Services fees: payments for assembly or manufacturing services
Gross profit
Sales, general and administrative expenses • Services fees: HQ allocations (management, accounting, legal, tax, insurance, HR), marketing and sales, R&D, • Allocation of headquarters costs • Rental payments: tangible and real property • Royalties for intangible property: trademarks,
Other • Interest income and expense on intercompany lending
Net profit before tax
Taxation
After tax profit
Balance sheet
Current assets/liabilities • Intercompany accounts payables and receivables • Short term lending, borrowing
Intangible assets • Use of brands, trademarks, patents, goodwill
Long term liabilities • Intercompany borrowing • External borrowing using parent company guarantees

[2] *See* Charles T. Horngren and Gary L. Sundem "Introduction to Management Accounting," p. 336, ninth edition. Prentice Hall International Inc. as cited in "History, State of the Art, Perspectives," United Nations Secretariat (September 2001).

[3] Reg. § 1.482-1(a)(1).

[4] Paragraph 3 of the Preface of the 1979 OECD Report on Transfer Pricing, as cited in "History, State of the Art, Perspectives," United Nations Secretariat (September 2001).

Absent transfer pricing rules, MNEs would be allowed to use transfer pricing to shift large amounts of income from one tax jurisdiction to another. The following table demonstrates how that benefit could be achieved through the reduction of the overall effective tax rate (ETR) if profits are shifted from a high-tax jurisdiction to a low-tax jurisdiction.

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Table 2 — Potential Benefit of Transfer Pricing on Global Effective Tax Rate (ETR)

	Parent (Country A)	*Subsidiary (Country B)*	*Consolidated*
Total profit reported on tax return	700	300	1,000
Tax rate	40%	10%	
Tax liability before change to transfer price	280	30	310
Global ETR			31%
ETR Effect of Transfer Pricing Change			
Total profit after using transfer pricing to shift 400 of income	300	700	1,000
Tax rate	40%	10%	
Tax liability after 400 transfer pricing change	120	70	190
Global ETR			19%

The potential for MNEs to use transfer pricing to shift income to low-tax jurisdictions was the subject of a Joint Tax Committee on Taxation Report[5] and a House Ways and Means Committee Hearing in 2010.[6] Although neither provided constructive guidance, legislators continue to be concerned about the potential for tax revenue loss through tax planning that involves transfer pricing issues. The provocatively-named Offshore Profit Shifting and the U.S. Tax Code Subcommittee Hearing focused on the offshore activities of U.S. multinational corporations. Senator Carl Levin's express intention was to demonstrate that corporations use or take advantage of weaknesses within the Internal Revenue Code and tax regulations concerning "transfer pricing" and other accounting rules to earn substantial U.S. profits without paying substantial U.S. taxes.[7] The corresponding memorandum issued by Senator Levin included case studies reflecting the tax planning and transfer pricing policies of a couple of MNEs.

In 2011, the Internal Revenue Service (IRS) began reorganizing its resources as part of a continuing effort to strengthen international tax compliance. The IRS realigned its transfer pricing resources, made new transfer pricing appointments, and created new divisions and enforcement tools. The Large and Mid-Size Business division (LMSB) was restructured as the Large Business and International division

[5] "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," Joint Committee on Taxation Report 37-10, July 20, 2010.

[6] "Ways and Means: Hearing on Transfer Pricing Issues," 111th Cong. (July 22, 2010).

[7] "Offshore Profit Shifting and the U.S. Tax Code" (Sept. 20, 2012).

(LB&I), which provides centralized focus on transfer pricing.[8] The reorganization also resulted in the creation of the new Transfer Pricing Practice group (TPP). TPP includes a group of transfer pricing specialists including international examiners, lawyers, economists and other experts that have been assembled and dispersed around the country to assist the IRS in its transfer pricing enforcement.[9] Samuel M. Maruca, the first IRS Director of Transfer Pricing Operations, is responsible for the development and coordination of LB&I's overall transfer pricing strategy and resourcing. The director also intervenes in selected important and complicated cases arising in examination, Competent Authority, and APAs.

The reorganization also saw the creation of the Advanced Pricing and Mutual Agreement (APMA) program, the inception of which was announced on July 27, 2011.[10] The program is the result of an amalgamation of the Advance Pricing Agreement (APA) program and Mutual Agreement Procedure (MAP) program. The Advance Pricing Agreement (APA) program was transferred to LB&I's Transfer Pricing Operations from the IRS Office of Chief Counsel. The Mutual Agreement Procedure office (MAP) was transferred to the same office. The creation of the APMA has already begun to speed up the resolution of APA cases.

Faced with the prospect of substantial revenue loss, the United States and most of its trading partners have increased their transfer pricing enforcement. If a taxpayer receives a transfer pricing adjustment in one Jurisdiction and does not obtain correlative relief in the other country, the taxpayer will suffer double taxation on the amount of the adjustment. The following table demonstrates the strong negative impact of double taxation on the MNE's effective tax rate.

[8] IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration. IR-2010-88, Aug. 4, 2010.

[9] IRS Official Elaborates on Plans For Transfer Pricing Pilot Program, 2010 *Tax Notes Today* 73-2 (Apr. 16, 2010).

[10] IR-2011-81.

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Table 3 — Detrimental Impact of Double Taxation on Effective Tax Rate (ETR)

	Parent (Country A)	*Subsidiary (Country B)*	*Consolidated*
Total profit reported on tax return	300	700	1,000
Tax rate	40%	10%	
Tax liability before Country B transfer pricing adjustment	120	70	190
Global ETR			19%
Double Taxation Effect on ETR			
Total profit after 400 Country A adjustment	700	700	1,400
Tax rate	40%	10%	
Tax liability after Country A transfer pricing adjustment[a]	280	70	350
Global ETR[b]			35%

[a] Note: Does not include penalty and interest amounts.

[b] Assumes no correlative relief from Country B.

¶ 120 Overview of Code Sec. 482

The United States enacted Code Sec. 482 to prevent tax avoidance and clearly reflect income by and among related entities and place a controlled taxpayer on parity with an uncontrolled taxpayer. Section 482 accomplishes this by determining, according to the standard of an uncontrolled taxpayer, the true and arm's length taxable income from the property or business of the controlled taxpayer.

From the taxpayer standpoint, Code Sec. 482 is the single largest tax issue for all foreign-based MNEs and nearly the largest single tax issue for U.S.-based MNEs.[11] The prospect of potential 20 or 40 percent penalties, possibility of double taxation, increased enforcement by the tax authorities, and significant documentation requirements ensure that transfer pricing issues continue to receive attention outside the tax department.[12] The magnitude and the growing impact of the transfer

[11] Transfer pricing adjustments and assessed penalties involve large dollar amounts. In September 2006, the U.S. subsidiary of U.K.-based pharmaceutical giant GlaxoSmithKline PLC (Glaxo UK) settled the largest tax case in the history of the United States Tax Court. The taxpayer agreed to $3.4 billion in tax deficiencies stemming from Code Sec. 482 adjustments from tax years 1989 through 2005. *See* "Glaxo Case Highlights Marketing Intangibles, Lack of U.S. Jurisprudence, Practitioners Say," 15 *Tax Mgmt. Transfer Pricing Rep.* 519 (Nov. 22, 2006).

[12] Recent initiatives by tax authorities in the United States and abroad reflect increased emphasis on transfer pricing enforcement. On January 22, 2003, the Commissioner of the IRS Large and Mid-Size Business Division (LMSB) issued a compliance directive to IRS examiners instructing them to examine and enforce strict compliance with transfer pricing documentation requirements, and to assert transfer pricing penalties when appropriate. *See* Memorandum for LMSB Executives, Managers, and Agents, "Transfer Pricing Compliance Directive," Jan. 22,

pricing rules in the U.S. and worldwide speaks for itself. As of 2010, more than 59 countries have adopted transfer pricing rules or followed general arm's length standards under the OECD (Organisation for Economic Co-operation and Development) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations;[13] more than 61 countries have either specific or ordinary penalties applicable to transfer pricing adjustments; and more than 56 countries have introduced documentation requirements in support of transfer pricing methods applied by taxpayers.[14]

¶ 130 Statutory Language and Scope of Code Sec. 482

.01 Statutory Language

Code Sec. 482 of the Internal Revenue Code ("Code") authorizes the Internal Revenue Service ("IRS") to reallocate income, deductions or tax attributes among the members of a controlled group of entities to prevent tax evasion or to ensure the clear reflection of income. Code Sec. 482 reads as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Code Sec. 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

With the exception of the last sentence, the statutory language of Code Sec. 482 is unchanged since originally enacted in 1928.[15] The last sentence was added in the Tax Reform Act of 1986 to combat perceived abuses regarding the transfer of intangibles developed through research and development.[16]

.02 Control

According to the statutory language, Code Sec. 482 is only applicable when two or more organizations, trades or businesses are controlled by the same interests. The term "control" is not defined in the Code. The regulations under Code Sec. 482 provide the following definition of the term "controlled":

> "Controlled" includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a

(Footnote Continued)

2003, available at: *http://www.irs.gov/Businesses/International-Businesses/Transfer-Pricing-Compliance-Directive* (last visited on April 30, 2013). Note that LMSB has since been restructured as LB&I.

[13] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of the Organisation for Economic Co-operation and Development Committee on Fiscal Affairs (1995).

[14] *See* Ernst & Young, Transfer pricing global reference guide (2012), available at: *http://www.ey.com/GL/en/Services/Tax/International-Tax/Transfer-Pricing-and-Tax-Effective-Supply-Chain-Management/2012-Transfer-pricing-global-reference-guide* (last visited on April 30 2013).

[15] Sec. 45 of the Revenue Act of 1928, 45 Stat. 806.

[16] Tax Reform Act of 1986, Pub. L. No. 99-514, Sec. 1231(e)(1), 100 Stat. 2085, 2562-63 (1986).

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common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.[17]

Caution: The definition of "control" for Code Sec. 482 purposes is broadly defined to include taxpayers acting in a common design and should not be confused with the Code Sec. 368(c) definition of control used for subchapter C purposes.[18]

IRS Guidance. When structuring transactions, taxpayers often consult IRS guidance, including IRS field service advice (FSAs). FSAs are addressed to IRS field officers and detail the IRS National Office's views on a particular transaction. Although FSAs are not authority that can be relied on by taxpayers, they could be helpful in identifying the types of issues that the IRS might raise.

The IRS applied Code Sec. 482 in a series of FSAs on the basis of contractual relationships entered into by completely unrelated third parties.[19] The IRS was particularly concerned that the income attributable to the sale/leaseback transactions was allocated to persons who were not subject to U.S. taxation and the related losses were allocated to U.S. taxpayers. Most practitioners found it troubling that none of the parties in those FSAs identified by the IRS as being "controlled by the same interests" would be treated as such under a traditional Code Sec. 482 transfer pricing analysis. There was no interrelated ownership, directorship, family control, or any other indicia of common control. Consequently, many practitioners viewed the IRS's use of Code Sec. 482 in this situation as somewhat suspect.[20]

In 2003, the IRS reversed its position to assert that an application of Code Sec. 482 to completely unrelated third parties on the basis of contractual relationships is not consistent with the policies underlying the statute. In Rev. Rul. 2003-96, the IRS stated that "the fact that parties that were unrelated up to, and including the time of, a transaction engage in that transaction in an attempt to arbitrarily shift income or deductions among themselves does not by itself evidence the type of control necessary to satisfy the 'acting in concert or with a common goal or purpose' requirement of Reg. § 1.482-1(i)(4)."[21] However, the previous IRS practice should not be overlooked in determining the existence of common control.

Court Cases. Neither Code Sec. 482 nor the regulations provide a "bright line" test for determining what constitutes control for transfer pricing purposes. Absent statutory and regulatory guidance, the IRS and taxpayers have sought to identify the indicia of control in court cases. The cases discussed below do not serve as a

[17] Reg. § 1.482-1(i)(4). Some commentators have noted the circularity of this last point. *See* John P. Warner, "Control, Causality, and Section 482," 8 *Tax Mgmt. Transfer Pricing Rep.* 289 (Jul. 28, 1999).

[18] *See Eli Lilly & Co.*, 88-2 USTC ¶ 9502, 84 TC 996, 1115 n. 50 (1985).

[19] *See*, e.g., FSA 199909005 (Nov. 17, 1998); FSA 199914018 (Jan. 5, 1999). *See also*, Notice 95-53, 1995-2 CB 334 and Notice 99-5, 1998-3 IRB 49.

[20] *See Phil Morrison, et al.*, "IRS Expands the Reach of Section 482," 8 *Tax Mgmt. Transfer Pricing Rep.* 105 (June 2, 1999).

[21] Rev. Rul. 2003-96, 2003-34 IRB 386; *see also* Notice 2003-55, 2003-34 IRB 395 (the Notice 2003-34 modified and superseded Notice 95-53 in response to *Andantech LLC*, 2003-1 USTC ¶ 50,530, 331 F.3d 972 (D.C. Cir. 2003), *aff'g* in part and *remanding*, CCH Dec. 54,714(M), TC Memo. 2002-97; *Nicole Rose Corp.*, 2003-1 USTC ¶ 50,137, 320 F.3d 282 (2d Cir. 2002), *aff'g per curiam* CCH Dec. 54,578, 117 TC 328 (2001).

clear guide on this issue, but they do demonstrate the application of the regulations to specific facts.

Courts have recognized that the language of Code Sec. 482 is "broad and sweeping, and its application depends on a finding of either ownership or control, thus allowing for a broad interpretation of the Code Sec. 482 by the IRS."[22]

Direct and Indirect Ownership/Voting Control. The scope of control is not limited to stock ownership percentages relating to voting rights. The taxpayer does not need to own a majority interest in one or more businesses to control them. It is the reality of control that is determinative.[23] In addition to where a party owns a majority of the stock of a corporation, courts have found common control in situations involving 50/50 ownership of the stock of a corporation.[24] Control was even found where only 2-percent of a corporation's outstanding stock was owned by two individuals who, according to the court, "were in effective control of the business."[25]

W.L. Gore & Associates, Inc.[26] involved a U.S. taxpayer (W.L. Gore & Associates, Inc.) that—together with Junkosha Ltd. (Junkosha), a Japanese corporation—formed JGT, a 50/50 joint venture, incorporated in Japan. In addition to JGT stock, the U.S. taxpayer owned 30 percent of the stock of Junkosha. The taxpayer discovered a new technology and entered into an agreement with JGT granting a royalty-free license to the joint venture. The IRS had asserted a deficiency under Code Sec. 482. The taxpayer moved for summary judgment, arguing that no common control of the taxpayer and JGT existed. The IRS opposed the taxpayer's motion for summary judgment on the ground that a trial would reveal additional facts, which would support the three bases for the IRS determination that the taxpayer controlled JGT, namely: (1) taxpayer's ownership of 50 percent of the stock of JGT and its ownership of 30 percent of Junkosha, which owned the other 50 percent of JGT; (2) taxpayer's managerial control of the use of new technology in Japan by JGT by virtue of the web of interlocking arrangements between petitioner, Junkosha, and JGT; and (3) the arbitrary shifting of income from taxpayer to JGT resulting from the royalty-free transfer of new technology from taxpayer to JGT pursuant to the agreement.

Noting that the question of control involves a factually intensive inquiry, the Tax Court denied the taxpayer's motion for summary judgment. The Court stated that it was not persuaded by the taxpayer that it should not take its 30-percent ownership of Junkosha into account because the attribution rules do not apply for purposes of Code Sec. 482. "The fact of the matter is that, for purposes of determining common control, indirect ownership is an element which can properly

[22] *Collins Electrical Co., Inc., a CA Corp.*, CCH Dec. 34,287, 67 TC 911, 918 (1977).

[23] Reg. § 1.482-1(i)(4); *see generally* Wayne M. Gazur, "The Forgotten Link: 'Control' in Section 482," 15 *J. Intl. Bus.* 1 (1994). *See also J.E. Hall, Sr.*, CCH Dec. 23,615, 32 TC 390, 410 (1959) (the court disregarded the question of the ownership, while holding that Hall completely controlled and dominated the corporation); *see also P.W. Ach*, CCH Dec. 26,743, 42 TC 114, 125 (1964) (the court held that "it is not record ownership, but actual control, which counts in the application of the statute.").

[24] *B. Forman Co.*, 72-1 USTC ¶ 9182, 453 F.2d 1144, 1155 (2d Cir.) *cert. denied*, 407 US 934 (1972). *See also W.L. Gore & Assoc., Inc.*, CCH Dec. 50,507(M), 69 TCM (CCH) 2037 (1995).

[25] *Charles Town, Inc.*, 372 F.2d 415, 420 (4th Cir. 1967), *aff'g* CCH Dec. 27,819(M), TC Memo. 1966-15.

[26] *W.L. Gore & Associates, Inc.*, CCH Dec. 50,507(M), TC Memo. 1995-96.

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be considered even if the usual standards for attribution of ownership, such as those found in Code Sec. 318, are not met."[27] Unfortunately, the court did not offer a methodology to compute indirect ownership for Code Sec. 482 purposes.

Acting in Concert. Each shareholder can individually still be considered to control the corporation if the shareholder and at least one other shareholder (two or more in total) act in concert with a common goal of shifting income or deductions from or to the corporation.[28] Thus, it is unimportant that each shareholder lacks actual or effective control of the corporation. Courts have inferred control from the actions of the parties.[29]

In *B. Forman Co.*,[30] the court held that two unrelated 50-percent corporate shareholders who exerted control over a corporation were both subject to Code Sec. 482 because they acted in concert to direct its actions, and they had a common goal of avoiding income tax on interest income. The court described the requisite control under Code Sec. 482 as one of "actual, practical control rather than any particular percentage of stock ownership." Here, B. Forman and McCurdy & Co. owned competing retail department stores. The two corporations had no common shareholders, directors, or officers. To revitalize business at their stores' locations, the two corporations formed a third corporation, Midtown, which would develop a shopping center linking the two stores. Each competitor owned fifty percent of the shares of the new shopping center corporation. Each of the two shareholders loaned money to the new corporation at interest rates considered inadequate by the IRS, which invoked Code Sec. 482 to impute interest income to the two shareholders. The court used "the realistic approach" and applied a common goal analysis in finding control. The court concluded that with respect to the two shareholders of Midtown "their interests in the existence and career of Midtown and the interests of Midtown are identical."

In *First Security Bank of Utah*,[31] the Supreme Court recognized that the IRS's authority to apply Code Sec. 482 is premised on the complete dominion (power) of common owners or managers to determine the actual economic results of the transacting business organizations. There, a holding company, First Security Corp. controlled two banks, First Security Bank of Utah and First Security Bank of Idaho; First Security Co., a management company; E.D. Smith & Sons, an insurance agency; and beginning in 1954, First Security Life Insurance Co. ("Security Life"), a life insurance company. In 1954, the banks began referring their credit life insurance business to an independent insurance company that then reinsured the policies with Security Life. Security Life retained 85-percent of the premiums for assuming the risks under the policies, and forwarded the remainder to the independent insurance company that provided actuarial and accounting services. No sales commissions were paid to either the banks or the management company. The Code

[27] *Id.*

[28] Reg. § 1.482-1(i)(4); *B. Forman Co., Inc., supra* note 24; *South Texas Rice Warehouse Co.*, 66-2 USTC ¶ 9619, 366 F.2d 890 (5th Cir. 1966), *aff'g* CCH Dec. 27,223, 43 TC 540 (1965), *cert. denied*, 386 US 1016 (1967).

[29] *Grenada Industries, Inc.*, CCH Dec. 18,468, 17 TC 231 (1951), *aff'd* 53-1 USTC ¶ 9271, 202 F.2d 873 (5th Cir. 1953), *cert. denied*, 346 US 819 (1953).

[30] *B. Forman Co., Inc.*, CCH Dec. 30,087, 54 TC 912, 921 (1970).

[31] *First Security Bank of Utah, N. A., et al.*, 72-1 USTC ¶ 9292A, 405 US 394, 404 (1972).

Sec. 482 adjustment followed. The Commissioner argued that a Code Sec. 482 allocation was appropriate because the banks would have been compensated for making the credit insurance available to their customers had the parties been dealing with each other at arm's length.

In applying the Code Sec. 482 regulations, the Court found that the holding company did not have the "complete power" to shift income among its subsidiaries required by the regulations, unless it acted in violation of the federal banking laws. The court stated that "the 'complete power' referred to in the regulations hardly includes the power to force a subsidiary to violate the law."[32]

Management Control. In *Charles Town, Inc.*,[33] two brothers owned all of the stock of Fairmount Steel Corporation ("Fairmount"), which had significant net operating loss carryovers. The brothers formed a new corporation, Charles Town, Inc. ("Charles Town"), to acquire a West Virginia race-track. A first cousin, and business associate, received 98-percent of the stock in Charles Town, while each brother received one percent. The brothers became the president and secretary-treasurer and directors of Charles Town, while the cousin was a vice-president and director. Fairmount agreed to advance funds to Charles Town to conduct racing at the track that Charles Town had leased from the owner. Charles Town operated the race track, retaining ten percent of the net profits, and paying the balance to Fairmount.

The court held that the brothers were in control of the "business" of Charles Town. The small stock ownership position of the brothers in Charles Town was supplemented by a provision in the management agreement that a majority of the officers would make all decisions for the corporation so long as Charles Town was indebted to Fairmount. This voting agreement gave the brothers practical control of Charles Town, and only 2-percent interest in Charles Town did not prevent the court from finding that control.

Common Goals and the Same Interests. In *South Texas Rice Warehouse Co.*,[34] the members of four families held identical shareholdings in two corporations. Those shareholders formed a new partnership to engage in the rice drying business, excluding two brothers who together owned 35-percent of each of the corporations. The taxpayers argued that the corporations and the partnership were not under the control of the same interests because the partners owned only 65-percent of each corporation, and the transaction in question, a lease, required the affirmative vote of shareholders holding at least 80-percent of the voting power of the corporations.

The Tax Court found that control was exercised. Although the excluded two brothers owned no interests in the partnership, the two corporations, which provided rice for processing by the partnership, and the partnership were an interdependent business operation that required the cooperation of all parties. The identities of the particular shareholders might have changed, but the overall control

[32] *Id.* at 495.

[33] *Charles Town, Inc.*, 67-1 USTC ¶ 9243, 372 F.2d 415, 420 (4th Cir. 1967).

[34] *South Texas Rice Warehouse Co.*, CCH Dec. 27,223, 43 TC 540 (1965).

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of the family enterprise did not change. The court held that the existence of common control was shown not only by the relationship of father and child with respect to the stockholders who permitted their family interest in the partnership to be taken over by their children, but also by the fact that the entire operations of the partnership were dependent on the overall family interests in various business entities.

Further, in *Brittingham*,[35] the Tax Court concluded that different persons acting with a common goal or purpose for artificially shifting income can constitute "the same interests" for purposes of the statute. There, two brothers each owned 37-percent of the stock of a U.S. ceramic tile distribution company, while one of the brothers owned all of the stock of a tile manufacturing company in Mexico which sold its products to the U.S. distributor. The IRS determined that the two companies were under common control and attempted to reallocate income from the Mexican company to the U.S. company.

In holding against the IRS, the Tax Court stated that different persons with a common goal or purpose for artificially shifting income can constitute the "same interest" for purposes of Code Sec. 482. Thus, it is not necessary that the same person or persons own or control each controlled business before Code Sec. 482 can apply, but there must be a common design for the shifting of income for different individuals to constitute the "same interest." The court reasoned that the brother who only had an interest in the U.S. company would not agree to shift income to a company in which he had no ownership because shifting of income would not be in his best economic interest. Further, the court stated: "to believe that Robert [one of the brothers] would be a part of a plan to divert $1.5 million from a corporation in which he and his children owned a 37-percent interest to a corporation in which his immediate family had no interest strains all credulity."

A similar holding was reached by the Tax Court in *Bransford*.[36] Here, a corporation sold real property to another company, the majority of which was owned by the owners of the selling company and an unrelated individual who owned 16.66-percent of the stock. The real property was sold by the purchasing company at a substantial gain. The IRS asserted that the companies were under common control and attempted to reallocate the purchase price to the selling company. The Tax Court reasoned that it was against the minority shareholder's self-interest to participate in a plan to shift $1.8 million from a company in which he had a minority interest to a company in which he had no ownership interest. Further, the court found that the minority shareholder, who also was the president of the company, would not expose himself to a shareholder suit for breach of fiduciary duty in protecting their interests.

Timing Issue. Determination of when control existed can be important to find whether certain transactions are controlled transactions within the meaning of

[35] *R.M. Brittingham, et al.*, CCH Dec. 33,856, 66 TC 373, 397-398 (1976), *aff'd per curiam*, 79-2 USTC ¶ 9499, 598 F.2d 1375 (5th Cir. 1979).

[36] *J.S. Bransford and H.D. Bransford, et al.*, CCH Dec. 34,641(M), TC Memo. 1977-314.

Code Sec. 482. In *DHL Corp.*,[37] the Tax Court held control to exist prior to the transaction.[38]

.03 No "Intent" Requirement

Code Sec. 482 grants authority to the IRS to make an allocation when such an allocation is necessary to clearly reflect income or prevent evasion of taxes or clearly to reflect the income. Therefore, Code Sec. 482 applies to all transactions between commonly controlled or related entities, regardless of taxpayer intent.[39] The IRS's authority extends to any case in which the taxable income of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.[40] For example, in *Ruddick Corp.*,[41] the United States Court of Claims held that proof of a valid business purpose or of good faith will not defeat Code Sec. 482 allocation.

> ***Comment:*** Officially, the statute is a one-way street. Code Sec. 482 grants no right to a controlled party to apply the provisions at will. Further, the statute does not grant any right to compel the IRS to apply these provisions.

The regulations provide taxpayers with two opportunities to affirmatively apply Code Sec. 482. First, taxpayers may report arm's length results on a timely-filed return that are different than the results reported on their books.[42] Second, taxpayers can claim setoff treatment with respect to favorable non-arm's length transactions between the controlled taxpayers that occurred in the same taxable year for which the IRS proposes a transfer pricing adjustment.[43]

No untimely or amended returns are permitted to decrease taxable income based on adjustments to controlled transactions.[44] Even though no express authority exists in the regulations for amended returns that increase taxable income, most practitioners believe that the IRS will accept the increased taxable income. Revenue Procedure ("Rev. Proc.") 99-32 provides additional guidance, explaining that if an adjustment results in an increase to U.S. taxable income, the taxpayer may report the adjustment "at any time"—that is, on either an original or an amended return.[45] However, if the adjustment results in a decrease in U.S. taxable income, the

[37] *DHL Corp.*, CCH Dec. 53,015(M), TC Memo. 1998-461, *aff'd* in part and *rev'd* in part, 2002-1 USTC ¶ 50,354, 285 F.3d 1210 (9th Cir. 2002).

[38] *DHL Corp.*, CCH Dec. 53,015(M), TC Memo. 1998-461. For the discussion of timing issue *see also* Wayne M. Gazur, "The Forgotten Link: 'Control' in Section 482," 15 *J. Intl. Bus.* 1 (1994).

[39] Reg. § 1.482-1(f)(1)(i).

[40] Reg. § 1.482-1(a). *See also Eli Lilly & Co.*, 88-2 USTC ¶ 9502, 84 TC 996 (1985); *G.D. Searle & Co.*, CCH Dec. 43,685, 88 TC 252 (1987) (in both cases, the Tax Court upheld a portion of the IRS's allocation based on the clear reflection of income standard).

[41] *Ruddick Corp.*, 81-1 USTC ¶ 9221, 643 F.2d 747 (Ct. Cl. 1981). *See also Eli Lilly & Co.*, 67-1 USTC ¶ 9248, 372 F.2d 990, 998-999 (Ct. Cl. 1967) where a valid business purpose was not dispositive of Code Sec. 482.

[42] Reg. § 1.482-1(a)(3).

[43] Reg. § 1.482-1(g)(4). A potential opportunity for taxpayers to affirmatively apply Code Sec. 482 is contained in the procedures for the APA Program. *See* Rev. Proc. 2006-9, IRB 2006-2, 278. Advance Pricing Agreements (APAs) allow taxpayers and the IRS to avoid future transfer pricing disputes by entering into a prospective agreement, generally covering at least five tax years, regarding the taxpayer's transfer prices. Under certain circumstances, APAs could be applied to resolve transfer pricing issues for prior taxable years (rollback). Rev. Proc. 2006-9 provides clarification that rollback is not available in the case of unilateral APA requests if the rollback would decrease taxable income on a return filed for a taxable year not covered by the APA (Rev. Proc. 2006-9, § 2.12). For the APA discussion, *see* Chapter 14.

[44] Reg. § 1.482-1(g)(3).

[45] Rev. Proc. 99-32, 1999-2 C.B. 296, Section 2.

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adjustment may only be reported on the original (timely-filed) return.[46] This prohibition against taxpayer-initiated downward transfer pricing adjustments was recently confirmed. In *Intersport Fashions West Inc. v. U.S.*, 109 A.F.T.R.2d 2012-927 (Fed. Cl. 2012), the United States Court of Federal Claims granted the IRS's Motion for Summary Judgment, holding that, based upon the "plain language" of the regulations, *Intersport* was not allowed to amend tax returns that were filed to make a downward transfer pricing adjustment.

In the context of an APA (*see* Chapter 14 for discussion of APAs), taxpayers are allowed to make an upward adjustment within the APA term.[47]

The MAP process was established to prevent double taxation arising under the application of treaty terms. Many governments, including the U.S., will direct taxpayers to make downward adjustments in accordance with the MAP outcome. Due to taxpayer involvement in the MAP process, the taxpayer is allowed relief that would not otherwise be available. However, Competent Authority has indicated reluctance to consider cases resulting from self-initiated transfer pricing adjustments. This is also true for non-U.S. government-initiated adjustments. The technical argument supporting this position generally focuses on the language in Reg. § 1.482-1(a)(3), the lack of action by either of the treaty partners in the case of a taxpayer-initiated adjustment, and on Rev. Proc. 2006-54, which states that the Accelerated Competent Authority Procedure (ACAP) is only available for U.S.-initiated adjustments. These arguments seems out of context, considering the requirements imposed on taxpayers by the various U.S. accounting and tax rules and regulations—including penalties (either in the U.S. or in foreign countries), FIN 48, and the new UTP (Uncertain Tax Positions) federal tax form—which can be viewed as actions of the U.S. government that compel taxpayers to take certain steps. If these steps result in double taxation, the MAP process should be available to mitigate the double tax.[48] The IRS is currently working on revising guidance on advance pricing and mutual agreement procedures. One of the revisions under consideration is the allowance of self-initiated adjustments in competent authority cases.

¶ 140 Burden of Proof

The IRS's deficiency determinations under Code Sec. 482 are presumptively correct.[49] Courts have at times referred to this as a "heavy" burden of proof on taxpayers.[50] Accordingly, the taxpayer bears the burden of proving that the IRS's

[46] *Id.*

[47] See 11.02 of Rev. Proc. 2006-9.

[48] *See* Steven C. Wrappe and Denen Boyce, "The Case For Allowing Competent Authority Assistance When the Taxpayer Makes a Self-Initiated Adjustment," 20 *Tax Mgmt. Transfer Pricing Rep.* ___ (Dec. 2011).

[49] *Welch v. Helvering*, 3 USTC ¶ 1164, 290 US 111, 115 (1933); *Eli Lilly & Co.*, 88-1 USTC ¶ 9502, CCH Dec. 42,113, 84 TC 996, 1131 (1985).

[50] *See*, e.g., *J. Procacci*, CCH Dec. 46,451, 94 TC 397, 414 (1990). Because the burden of proof is a litigation concept, it is not discussed in the Code Sec. 482 or regulations thereunder.

Generally, taxpayers are faced with the burden of proof when arguing their cases in courts (as discussed in more detail in Chapter 12, taxpayers in the U.S. have opportunities to argue their cases before the Tax Court, federal court of claims and district courts). The burden of proof consists of the duty to bring forward evidence (the burden of production) and of the risk of nonpersuasion (the burden of persuasion). *See P. Anastasato*, 86-2 USTC ¶ 9529, 794 F.2d 884, 887 (3d Cir. 1986).

determinations under Code Sec. 482 are incorrect.[51] It is not sufficient for the taxpayer to rebut the presumption of correctness of IRS determinations, but rather the taxpayer must show that the IRS acted in an arbitrary and unreasonable manner. If the taxpayer successfully rebuts the Commissioner's presumption,[52] the burden of production shifts to the government. However, the taxpayer must still carry the ultimate burden of proof or persuasion.[53]

A taxpayer may satisfy its burden in one of two ways:[54]

- Establish that its prices were arm's length under Code Sec. 482 and the regulations;[55] or
- Establish that the IRS's determinations were arbitrary, capricious, or unreasonable.[56]

In short, the IRS's deficiency determination will be sustained by a court absent a showing by the taxpayer that the IRS abused its discretion.[57] Whether the IRS has abused its discretion is a question of fact.[58] To make its determination, the court's task is to review the result of the allocation, and not necessarily the methodology used to reach its result.[59] Again, taxpayers must show that the IRS's allocations are arbitrary, unreasonable, and capricious before taxpayers can show their view of ascertaining an arm's length result. This standard by definition has released the government of meeting a reasonable standard in pursuing an assessment. However, in some cases, where the IRS attempts to establish that common control exists due to arbitrary shifting of income, the IRS has a burden of proving that arbitrary shifting of income took place.[60]

In *DHL Corp.*,[61] the taxpayer challenged the IRS's presumption of correctness. The taxpayer argued that it should be held to a lesser standard of showing, by a preponderance of the evidence, that its prices were arm's length because the IRS

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[51] *Welch v. Helvering*, 3 USTC ¶ 1164, 290 US 111, 115 (1933); *Eli Lilly & Co.*, 88-1 USTC ¶ 9502, CCH Dec. 42,113, 84 TC 996, 1131 (1985). *See also* United States Tax Court Rule 142(a).

[52] In *J.W. Stout*, 60-1 USTC ¶ 9185, 273 F.2d 345 (4th Cir. 1959), the Fourth Circuit stated: "The presumption of correctness is procedural. It transfers to the taxpayer the burden of going forward with evidence, but it disappears in a proceeding to review the assessment when substantial evidence contrary to the Commissioner's finding is introduced."

[53] *Danville Plywood Corp.*, 90-1 USTC ¶ 50,161, 899 F.2d 3 (Fed. Cir. 1990), *aff'g*, 89-1 USTC ¶ 9248, 16 Cls. Ct. 584, 593-94 (1989). The courts recognized that the burden of proof signifies the burden of persuasion, and it remains with the taxpayer and never shifts to the government throughout the whole proceeding. It is the burden of production that can be shifted.

[54] To clarify, the burden of proving here goes beyond of just rebutting the presumption of correctness of IRS deficiency determinations.

[55] *Asiatic Petroleum Co.*, CCH Dec. 8868, 31 BTA 1152, 1157 (1935) *aff'd* 35-2 USTC ¶ 9547, 79 F.2d 234 (2d Cir. 1935); *Seagate Technology, Inc.*, CCH Dec. 49,657, 102 TC 149 (1994).

[56] *Sundstrand Corp.*, CCH Dec. 47,172, 96 TC 226, 353 (1991); *Westreco Inc.*, 64 TCM (CCH) 849 (1992); *P.W. Ach*, 66-1 USTC ¶ 9340, 42 TC 114 (1964) *aff'd*, 358 F.2d 342 (6th Cir. 1966).

[57] *Bausch & Lomb, Inc.*, CCH Dec. 45,547, 92 TC 525, 582 (1989), *aff'd* 91-1 USTC ¶ 50,244, 933 F.2d 1084 (2d Cir. 1991). *See generally* Francis M. Allegra, "Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review," 13 *Va. Tax Rev.* No. 3, 423 (1994).

[58] *Sundstrand, supra* note 56, CCH Dec. 47,172, at 353-354.

[59] Reg. § 1.482-1(f)(2)(v); *Bausch & Lomb, supra* note 57, CCH Dec. 45,547 at 582.

[60] Proof of shifting of income between two corporations establishes presumption of common control, but when government seeks to show applicability of Code Sec. 482 by this method, it has the burden of proving of shifting of income; although allocation of Code Sec. 482 is presumptively correct and it is insufficient for taxpayer to merely show that its determination of arm's length price is wrong, in order to arrive at that position, government must show that there was common control of corporation so that Code Sec. 482 applies. *Dallas Ceramic Co.*, 79-2 USTC ¶ 9500, 598 F.2d 1382 (1979).

[61] *DHL Corp.*, CCH Dec. 53,015(M), TC Memo. 1998-461, *aff'd in part* and *rev'd in part*, 285 F.3d 1210 (9th Cir 2002).

issues. Therefore, a taxpayer may file a refund claim after executing a Form 870, but not after executing a Form 870-AD. There exists a split of authority over the finality of a Form 870-AD. Some courts apply an estoppel theory to prevent taxpayers from reopening issues resolved by way of a Form 870-AD.[54] Some courts have held, however, that only agreements meeting the requirements of Code Sec. 7121, a requirement not met by Form 870-AD, operate as a final settlement of issues, absent material misrepresentations by the taxpayer.[55] The IRS will not re-open cases closed by either a Form 870 or 870-AD absent:

- Fraud, malfeasance, collusion, concealment, or misrepresentation of material fact;
- The existence of substantial error in the settlement or closing, based on established IRS positions existing during the audit; or
- Circumstances indicating that failure to re-open would be a serious administrative omission.

Because Forms 870 do not constitute closing agreements within the meaning of Code Sec. 7121, they do not limit the relief available from competent authority.[56] However, the IRS takes the position that Appeals settlements reflected on Forms 870-AD constitute "other written agreements," and consequently competent authority will only seek correlative adjustments from foreign competent authorities if the taxpayer has executed a Form 870-AD.

.02 Closing Agreements

Code Sec. 7121 provides the authority for the IRS to enter into formal closing agreements. Formal closing agreements conclusively settle the issues encompassed by the agreement absent fraud, malfeasance, or misrepresentation of material fact.[57] In transfer pricing cases, U.S. competent authority will only seek correlative adjustments from the treaty partner when the IRS and taxpayer enter into a closing agreement relating to the transfer pricing issues.[58]

.03 When to Discuss Form of Agreement

The timing of the discussion regarding the form of the closing agreement depends on the taxpayer's overall strategy for resolving the case. Large case examination teams understand the taxpayer's options regarding Appeals and competent authority. If the taxpayer can tolerate a limited amount of double taxation, the examination team may resolve the case for a lesser amount than it would otherwise if the taxpayer agrees to enter into a formal closing agreement. However, if the examination team or Appeals believes the taxpayer will proceed to competent authority, they will have less incentive to reduce the adjustment in the belief that a higher assessment will be to the advantage of competent authority during its negotiations. Therefore, the size of the adjustment, the availability of competent authority assistance, and the taxpayer's ultimate strategy all contribute to the taxpayer's decision of when and how to discuss the closing documentation.

[54] *See* e.g., *M.R. Flynn*, 86-1 USTC ¶ 9285, 786 F.2d 586 (3d Cir. 1986); *A.L. Stair*, 75-1 USTC ¶ 9463, 516 F.2d 560 (2d Cir. 1975).

[55] *See W. Whitney*, 87-2 USTC ¶ 9503, 826 F.2d 896 (9th Cir. 1987).

[56] Rev. Proc. 2006-54, at § 7.05.

[57] *See* Code Sec. 7121(b) (explaining the finality associated with the signing of closing agreements, absent circumstances of fraud, malfeasance, or misrepresentation of a material fact).

[58] Rev. Proc. 2006-54, at § 7.05.

Chapter 10

Preparing Transfer Pricing Documentation

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¶ 1001 Overview

A number of U.S. treaty partners have voiced concerns that the emphasis placed by the United States on transfer pricing enforcement (particularly penalties) encouraged taxpayers to shift income to the United States.[1] In response, these countries have taken action to protect their revenue bases and discourage the shifting of income to the United States or any other country. Over the past few years, most of the major trading partners have either added transfer pricing rules to their tax laws or substantially modified their existing rules to be consistent with the revised OECD guidelines. These countries include: Australia, Brazil, Canada, China, Denmark, France, Germany, Hong Kong, India, Italy, Japan, Korea, Mexico, New Zealand, Russia, Spain and the United Kingdom and including certain Eastern European countries. These countries and others have increased their enforcement efforts and many are considering enacting penalties and recordkeeping requirements.

¶ 1010 U.S. Documentation Requirements

The IRS's inability to obtain taxpayer information has historically been the main obstacle to its effective enforcement of U.S. transfer pricing laws.[2] When taxpayers have delayed or resisted IRS information requests, the IRS has been unable to develop a supportable and sustainable case. Two other impairments to

[1] *See generally*, OECD Guidelines ¶ 4.26 ("[A] penalty system in one jurisdiction may give taxpayers an incentive to overstate taxable income in that jurisdiction").

[2] *See*, A Study of Intercompany Pricing Under Section 482 of the Code, Notice 88-123, Chapter 3, 1988-2 CB 458, 461 (hereinafter referred to as the "White Paper").

IRS enforcement efforts have been inadequate resources and the inherent subjectivity in the application of the transfer pricing regulations. More recently, the U.S. government has made a concerted effort to reverse the unsatisfactory IRS enforcement record with statutory, regulatory and administrative changes. The combined impact of these changes has greatly enhanced the IRS ability to enforce U.S. transfer pricing laws and produced much more stringent practices on taxpayers including expansive documentation requests during the course of audit examinations.

.01 Reporting of Related Party Transactions

In 1989 and 1990, Congress amended Code Sec. 6038A and added Code Sec. 6038C to require disclosure of certain related party transactions and the maintenance of accessible books and records. Pursuant to these sections, (1) foreign corporations related to U.S. taxpayers, and (2) certain foreign-owned U.S. corporations and foreign corporations engaged in a U.S. trade or business through a branch must disclose information with respect to certain related party transactions on an annual basis. These disclosures are made on IRS Forms 5471 and 5472. (*See* ¶ 20,050 for the forms.)

.02 Contemporaneous Documentation Requirements

As stated above, the creation and maintenance of contemporaneous transfer pricing documentation is a prerequisite to avoiding penalties. Contemporaneous means prepared on or before the filing of the relevant federal tax return. There are two categories of documentation that a taxpayer must maintain—principal documents and background documents. The principal documents must include:

1. An overview of the taxpayer's business, including an analysis of the economic and legal factors affecting pricing;
2. A description of the taxpayer's organizational structure covering all related parties engaged in transactions potentially relevant under Code Sec. 482;
3. Any documentation specifically required by the regulations under Code Sec. 482 (e.g., documents related to a qualified cost sharing arrangement);
4. A description of the method selected and an explanation of why that method was selected;
5. A description of the alternative methods that were considered and an explanation of why they were not selected;
6. A description of controlled transactions and any internal data used to analyze those transactions;
7. A description of the comparables that were used, how comparability was evaluated, and what adjustments (if any) were made;
8. An explanation of the economic analysis and projections relied upon in developing the method;
9. A description or summary of any relevant data obtained after the end of the tax year and before filing a tax return; and

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10. A general index of the principal and background documents and a description of the recordkeeping system used for cataloguing and accessing those documents.

The last two items on the list need to be provided within 30 days of a request, but do not have to be prepared at the time the return is filed.[3] The IRS is currently strongly enforcing this 30-day rule.

The background documents, which support the assumptions, conclusions, and positions contained in the principal documents, may include the documents required under the Code Sec. 6038A regulations, such as original entry books and records and profit and loss statements, or other documents not specifically listed in either set of regulations, which the IRS determines are necessary to establish that the taxpayer's method was selected and applied in a way that provides the most reliable measure of an arm's length result.[4] Background documents need not be provided to the IRS unless they are specifically requested, and the 30-day period for producing the documents can be extended.[5] The current IRS practice is to seek these documents and more.

¶ 1020 OECD Documentation Requirements

.01 OECD

In July, 1995, the OECD published transfer pricing guidelines (the "Guidelines") that focus on the application of the arm's length principle to evaluate the transfer pricing of multinational corporations ("MNCs"). Guidance in Chapter V of the Guidelines was provided to assist taxpayers in identifying documentation that would be most helpful in showing that their controlled transactions satisfy the arm's length principle.[6] Under the guidelines, the following types of information should be made available through documentation, although it is neither a minimum compliance list nor an exclusive list of information that tax administrators may be entitled to request:

1. Information about the associated enterprises involved in the controlled transactions, the transactions at issue, the functions performed, and information derived from independent enterprises engaged in similar transactions or businesses.
2. Information regarding the nature and terms of the controlled transactions, economic conditions and property involved in the transactions, how the product or service that is the subject of the controlled transaction in question flows among the associated enterprises, and changes in trading conditions or renegotiations of existing arrangements;
3. Description of the circumstances of any known transactions between the taxpayer and an unrelated party that are similar to the transaction with a

[3] Reg. § 1.6662-6(d)(2)(iii)(A).

[4] Reg. § 1.6662-6(d)(2)(iii)(C).

[5] Reg. § 1.6662-6(d)(2)(iii)(C).

[6] Levey and Shapiro, "OECD Transfer Pricing Avoids Overpapering the Best Method," 6 *J. Int'l Tax* 52 (Feb. 1995); Levey and Shapiro, "OECD Transfer Pricing Draft Targets Excessive Documentation," 6 *J. Int'l Tax'n* 244 (June 1995); Levey and Shapiro, "OECD Transfer Pricing Rules Stress Dispute Resolution Methods," 6 *J. Int'l Tax'n* 301 (July 1995).

foreign associated enterprise and any information that might bear upon whether independent enterprises dealing at arm's length under comparable circumstances would have entered into a similarly structured transaction;

4. Outline of the business, structure of the organization, and ownership linkages within the MNC group;
5. Information about the amount of sales and operating results from the last few years preceding the transaction;
6. Information on pricing, including business strategies and special circumstances at issue.

Among the countries that do not have specific documentation provisions, but follow the OECD Guidelines, are Belgium, the Czech Republic, Singapore and Sweden.

¶ 1030 Pacific Association of Tax Administrators

.01 Pacific Association of Tax Administrators

On March 13, 2003, PATA released its "Transfer Pricing Documentation Package," (the "PATA Documentation Package") which provides for a harmonized transfer pricing documentation procedure among PATA member states, namely, Australia, Canada, Japan, and the United States. Compliance with the PATA Documentation Package, which is voluntary, requires that taxpayers prepare one set of documentation that will meet the transfer pricing documentation requirements of all the PATA members. Taxpayers that choose to use the PATA documentation package to avoid the imposition of PATA member transfer pricing penalties must satisfy three operative principles. MNCs must: (1) make reasonable efforts to establish arm's length transfer prices; (2) maintain contemporaneous documentation of their efforts to comply with the arm's length principle; and (3) produce, in a timely manner, that documentation upon request by a PATA member tax administrator.

This PATA Documentation Package seeks to respond to the potential difficulties that MNCs face in complying with the laws and administrative requirements of multiple tax jurisdictions. By providing taxpayers with the option of applying this uniform documentation package, the PATA members intend to help taxpayers efficiently prepare and maintain useful transfer pricing documentation, and timely produce such documentation upon request to PATA member tax administrations while precluding any related transfer pricing penalties. This documentation package is intended to be consistent with the general principles outlined in Chapter V of the OECD Guidelines, although the package has drawn criticism for the significant level of detail required, which is perceived to be greater than that required by any particular member country.

The documentation required by PATA is, by contrast to some countries, quite extensive and arguably greater than that required by the participating member countries. Among other things, the following information and documentation is necessary to comply with the PATA documentation requirements:

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1. Description of the nature of the business/industry and market conditions, including an identification of the participants in the related party dealings and their relationship;
2. Description of taxpayer's worldwide organizational structure (including an organization chart) covering all associated enterprises engaged in transactions potentially relevant to determining an arm's length price for the documented transactions;
3. Outline of the business including a relevant recent history of the taxpayer, the industries operated in, the general economic and legal issues affecting the business and industry, and the taxpayer's business lines;
4. Analysis of the economic and legal factors that affect the pricing of taxpayer's property and services;
5. Description of intangible property potentially relevant to the pricing of the taxpayer's property or services in the controlled transactions;
6. Information as to the functions performed, assets employed and risks assumed relevant to the transactions
7. Description of the controlled transactions that identifies the participants, the property or services to which the transaction relates and any intangible rights or property attached thereto, the scope, timing, frequency of, type, and value of the controlled transactions (including all relevant related party dealings in relevant geographic markets), as well as the currency of the transactions, and the terms and conditions of the transactions and their relationship to the terms and conditions of each other transaction entered into between the participants;
8. Copies of all relevant inter-company agreements;
9. Relevant information regarding business strategies and special circumstances at issue, for example, set-off transactions, market share strategies, distribution channel selection and management strategies that influenced the determination of transfer prices;
10. Information concerning cost contribution agreements to which the taxpayer is a party;
11. If the taxpayer pursues a market share strategy, documentation demonstrating that appropriate analysis was done prior to implementing the strategy, that the strategy is pursued only for a reasonable period, and that the costs borne by each associated enterprise are proportionate to projected benefits to such enterprise
12. Description of the comparables including, for tangible property, its physical features, quality, availability; for services, the nature and extent of the services; and for intangible property, the form of the transaction, the type of intangible, the rights to use the intangible that are assigned, and the anticipated benefits from its use;
13. For the taxpayer and the comparable firms, identify the factors considered when evaluating comparability, including the characteristics of the prop-

erty or service transferred, the functions performed (and the significance of those functions in terms of their frequency, nature and value to the respective parties), the assets employed (taking into consideration their age, market value, location, etc.), the risks assumed (including risks such as market risk, financial risk, and credit risk), the terms and conditions of the contract, the business strategies pursued, the economic circumstances (for example, the geographic location, market size, competitive environment, availability of substitute goods and services, levels of supply and demand, nature and extent of government regulations, and costs of production, etc.), and any other special circumstances;

14. Information about criteria used in the selection of comparables including database screens and economic considerations;
15. Information about adjustments made to the comparables, aggregation analysis (grouping of transactions for comparability), the supporting Transfer Pricing Methodology or methodologies used, if any;
16. Information and documentation about the selected TPM, the data and methods considered and the analysis performed to determine the transfer pricing, and an explanation of why alternate methods considered were not selected;
17. Documentation of assumptions and judgments made in the course of determining an arm's length outcome; and
18. Information about updates made to prior year documentation relied upon in the current year to reflect adjustments for any material changes in the relevant facts and circumstances.

Despite the benefits available to taxpayers that attempt to satisfy documentation requirements in multiple PATA jurisdictions by preparing "PATA-compliant" documentation, practitioners have identified several problems with this procedure.[7] While the PATA guidelines state that the required documentation should not impose higher documentation requirements than those set forth in any PATA member's local laws, this is not necessarily the case. Additionally, while the PATA Documentation Package provides a uniform system for creating documentation, it leaves the question of whether taxpayers have used "reasonable efforts" to prepare documentation subject to determination by local tax authorities under their respective local laws. Finally, while the PATA Documentation Package requires substantial information about a MNC's comparable transactions to support the arm's length nature of the its transfer pricing, it contains no guidance as to the nature of the comparable transactions, whether local comparables must be used, or whether some form of blended comparable is required.[8]

[7] *See* Tropin, "PATA Documentation Package Seen Offering Little Help with Compliance Burden, Penalty Insurance," 12 *Tax Mgmt. Transfer Pricing Rep.* 1 (May 2003).

[8] *See* Lebovitz, van Herksen, Kirschenbaum and Nijhof, "Achieving Transfer Pricing Com-PATA-bility," 14 *J. Int'l Tax'n*, Vol. 14, Part 9, pp. 14-19 (Sept. 2003).

¶ 1040 Preparing and Relying on Transfer Pricing Documentation

.01 Overview

As previously discussed, the amount of any IRS transfer pricing adjustment that relates to transactions that are included within the transfer pricing documentation requirement of Reg. § 1.6662-6(d)(2), will not be included in the calculation of whether the 20 percent or 40 percent understatement penalties will apply. This section discusses the preparation of transfer pricing documentation pursuant to the U.S. rules. Following sections will discuss OECD and foreign documentation requirements as well as methods for satisfying multiple jurisdictions with the same set of transfer pricing documentation. This section is not intended to be an exacting "how-to" guide because there is no set standard for the preparation of documentation. Instead, it will give a rather detailed outline of the U.S. documentation process. However, before discussing the U.S. transfer pricing documentation process in greater detail, it is important to keep the following points in mind.

Subjectivity. The process of determining arm's length transfer prices and transfer pricing documentation is inherently subjective. Therefore, except for the case of an exact CUP or CUT, the arm's length transfer price will be found in a range of prices.

Disclosure. Although transfer pricing documentation can be viewed as being prepared in anticipation of an audit or litigation, it is not subject to the attorney-client, or the accountant-client, but in certain instances may be subject to evidentiary privileges as the attorney work product doctrine. In fact, transfer pricing documentation *must* be turned over to the IRS within 30 days of a request in order to comply with the regulations. Therefore, transfer pricing documentation should be prepared with the intent to demonstrate the taxpayer's compliance with the Code Sec. 482 arm's length standard, and not in a manner that critically examines the weaknesses of the taxpayer's transfer pricing practices.

.02 Factors Considered in Determining Compliance

To avoid the imposition of penalties, the taxpayer, through the preparation of transfer pricing documentation, must be able to reasonably conclude that, given the available data, its selection of the method for determining transfer prices and the application of such method satisfies the best method rule.[9] This requires the taxpayer to make a reasonable effort to evaluate the potential applicability of other TPMs.[10] However, the taxpayer need not make an exhaustive analysis or detailed application of each method. Instead, after a reasonably thorough search for data, the taxpayer should consider which TPM would satisfy the best method rule given that data.[11] However, the regulations recognize that the nature of the available data may allow for only the cursory consideration of alternative TPMs (e.g., the availability of CUPs may eliminate the need to make a detailed CPM analysis). In addition, the taxpayer is not required to analyze whether an unspecified TPM would satisfy

[9] Reg. § 1.6662-6(d)(2)(ii).

[10] Reg. § 1.6662-6(d)(2)(ii).

[11] Reg. § 1.6662-6(d)(2)(ii).

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the best method rule.[12] Whether the taxpayer's conclusion was reasonable is determined after considering all facts and circumstances. Several factors to be considered include the following:

Taxpayer Experience. The taxpayer's experience and knowledge of transfer pricing is relevant in determining how thorough and precise its transfer pricing analysis must be.[13] For this purpose, transfer pricing experience and knowledge will be determined on a controlled-group basis.[14] Consequently, a relatively minor subsidiary in a substantial multinational group would not likely be able to claim to have little or no transfer pricing experience.

> ***Comment:*** The inference made by this regulation that the transfer pricing knowledge of the significant members of a multinational group is imputed to the less significant members of the same group, while being theoretically true and necessary on a regulatory basis, is not necessarily true in practice. The collective experience of the authors indicates that it is not uncommon to find a tax director of a relatively minor (sales less than $100 million) subsidiary of a multinational group with little or no transfer pricing experience.

Availability of Data. A taxpayer must conduct a reasonably thorough search for the data necessary to determine which TPM satisfies the best method rule and how that method should be applied.[15] In making this search, the taxpayer may weigh the expense of additional search efforts against: (i) the likelihood that they will find additional data that will improve the reliability of the results, and (ii) the amount by which any new data would change the taxpayer's taxable income.[16] In addition, the preamble to the final regulations indicates that as the amount of taxable income potentially at stake declines (either because of low dollar amounts of the controlled transactions or because of low variability in expected results), the need to search for additional data decreases.

Taxpayers must prepare their transfer pricing documentation using only the data available before the end of the taxable year.[17] This rule represents a change from the proposed and temporary regulations, which required the use of the most current data available prior to the filing of the tax return. This requirement was criticized by taxpayers and commentators as being unduly burdensome because taxpayers would be required to continuously update their transfer pricing analysis if they acquire additional data before their return was filed. Although the final regulations have eliminated the requirement of the proposed and temporary regulations, they do require the taxpayer to include that data as a principal document in its documentation report if the taxpayer acquires additional relevant data before the time that the tax return is due.[18]

Compliance with Other Code Sec. 482 Requirements. Another factor considered is the extent to which the taxpayer complied with the requirements in the substantive regulations under Code Sec. 482 regarding the application of the

[12] Reg. § 1.6662-6(d)(2)(ii).
[13] Reg. § 1.6662-6(d)(2)(ii)(A).
[14] Reg. § 1.6662-6(d)(2)(ii)(A).
[15] Reg. § 1.6662-6(d)(2)(ii)(B).
[16] Reg. § 1.6662-6(d)(2)(ii)(B).
[17] Reg. § 1.6662-6(d)(2)(ii)(B).
[18] Reg. § 1.6662-6(d)(2)(ii)(B).

TPMs (e.g., whether the taxpayer made adjustments to the comparables to increase accuracy).[19]

Reliance on Professionals and Prior Analyses. In preparing their transfer pricing documentation, taxpayers may reasonably rely on a study or other analysis prepared by a qualified professional such as an accountant, economist, or attorney.[20] It does not matter whether the professional is an employee or is otherwise related to the taxpayer so long as the analysis is objective, thorough, and well-reasoned.[21] Reliance on a professional is reasonable only if the taxpayer discloses all relevant information regarding the controlled transactions at issue.

> ***Comment:*** Failure to satisfy this requirement led to the imposition of transfer pricing penalties in the *DHL* case.

The regulation also allows the taxpayer to reasonably rely on a study prepared for a prior year if the relevant facts and circumstances have not changed or if the study has been appropriately modified to reflect any change in facts or circumstances.[22]

> ***Comment:*** Although this regulation contemplates the use of a transfer pricing study for more than one tax year, thus lowering compliance costs, there are instances where a taxpayer would want to obtain a new study. For instance, the cost of a new study may be more than offset by lower required profitability if the taxpayer operates in an industry experiencing losses. In addition, if the other party to the controlled transaction is in need of cash, conducting a new study *may* allow for lower profitability for the taxpayer, and thus higher profitability (and more cash) for the other party.

Selection of Comparables. Another factor to consider is whether the taxpayer arbitrarily selected its comparables with the intention of arriving at a low arm's length range.[23]

Prior Approved TPMs. Another factor to consider is whether the TPM applied by the taxpayer was specifically approved by the IRS in a prior APA or examination for a prior year.[24] In such a case, the taxpayer must also demonstrate that it applied the TPM in a manner that is reasonable and consistent with its previously approved application.[25] In addition, the taxpayer must show that the facts and circumstances surrounding the previous application of the TPM have not materially changed, or if they have, that appropriate adjustments have been made.[26]

Relative Size of the Adjustment. The last of the specified factors is a consideration of the size of the net transfer pricing adjustment relative to the size of the controlled transaction from which the adjustment originated.[27]

[19] Reg. § 1.6662-6(d)(2)(ii)(C).
[20] Reg. § 1.6662-6(d)(2)(ii)(D).
[21] Reg. § 1.6662-6(d)(2)(ii)(D).
[22] Reg. § 1.6662-6(d)(2)(ii)(D).
[23] Reg. § 1.6662-6(d)(2)(ii)(e).
[24] Reg. § 1.6662-6(d)(2)(ii)(F).
[25] Reg. § 1.6662-6(d)(2)(ii)(F).
[26] Reg. § 1.6662-6(d)(2)(ii)(F).
[27] Reg. § 1.6662-6(d)(2)(ii)(G).

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¶ 1050 The Transfer Pricing Report

The principal transfer pricing documents specified in Reg. § 1.6662-6(d)(2)(iii)(B) are usually included within a report prepared by a qualified transfer pricing professional. This Report typically contains a narrative description of the controlled taxpayers and the controlled transactions followed by an economic analysis that supports the use of the selected TPM as the best method for evaluating the transfer prices. (See the Practice Tools at ¶ 20,060 and ¶ 20,070 for a Model Transfer Pricing Documentation Outline and Process Steps in Transfer Pricing Documentation, respectively.)

.01 Description of the Taxpayer and Covered Transactions

Taxpayer Description. The Report should begin with an introduction of the taxpayer and its related parties. This introduction should include an organizational chart and describe the structure of the worldwide group, the roles of each entity within the group, and the industries in which the entities compete. Ideally, the report should provide the following information with respect to each of the relevant entities:

- Legal name and employer identification number;
- Legal status (corporation, partnership, branch, joint venture, disregarded entity, etc.);
- Country of incorporation and tax residence;
- Ownership structure and percentages of ownership;
- Type of business conducted (e.g., manufacturing, distribution, retail, R&D, etc.);
- The nature of products or services provided;
- Description of customers (e.g., retail v. wholesale, geographic locations); and
- Description of suppliers.

> ***Comment:*** This information can usually be found in the taxpayer's annual report, other SEC filings, internet site, marketing materials, and through the corporate secretary's office.

This introduction should also provide a fairly detailed description of the taxpayer's industry. In doing so, the following information should be provided:

- Type of industry (e.g., automotive, pharmaceutical, consumer goods, etc.);
- Competition within the industry (e.g., number and type of competitors, market shares, barriers to entry, whether the good or service is considered a commodity);
- External factors affecting the industry (e.g., technological advances, foreign exchange, global economies, domestic or foreign legal restrictions, etc.)

> ***Comment:*** This information can usually be found in the taxpayer's annual report, other SEC filings, Internet site, marketing materials, and trade publications.

Covered Transactions. Following a description of the taxpayer, its industry, and its business, the report should identify and describe the controlled transactions that will be the subject of transfer pricing documentation.

> ***Comment:*** It would also be appropriate at this point to identify and catalog all controlled transactions between the taxpayer and related entities, whether or not consideration is paid. While not all controlled transactions must be the subject of the Report (e.g., small transactions), cataloging all controlled transactions is useful in identifying transactions that would otherwise be overlooked. In addition, it should be kept in mind that not all controlled transactions are readily recognizable. Examples of such transactions that are sometimes overlooked include: the provision of technical assistance or administrative services; the use of trade names or designs, know-how, customer lists, or distribution networks; or loans in the form of intercompany receivables.

Each transaction that will be covered by the Report should be described in detail, with particular emphasis on the following information:

- Type of transaction (e.g., tangible goods, services, intangibles, loans, etc.);
- Copies of any contracts concerning the covered transactions;
- The amount of consideration received and how the amount was determined;
- Any costs incurred by the taxpayer in obtaining the goods that were sold or in providing the services; and
- Reasonable alternatives available to the taxpayer (i.e., unrelated suppliers).

.02 Functional and Risk Analysis

The purpose of the functional analysis is to determine how each related party adds value to the covered transaction, which, in turn, is used to assess the comparability of prospective uncontrolled transactions or entities. The theory behind the functional analysis is that each function or risk has an impact on the transaction's pricing or profitability. This analysis requires a review of the functions performed, assets (tangible or intangible) and skills used, and risks assumed by each related party.

> ***Comment:*** In practice, a functional analysis is really an exercise in transfer pricing issue spotting. The information for the functional analysis is usually obtained through databases, contract reviews, annual reports, taxpayer interviews, site-visits, and library and internet research. However, as with any issue-spotting exercise, facts must be established based on economic substance, and not merely by reviewing documents.

Some of the specific functions that must be identified and reviewed include:

- Type of activity performed (i.e., manufacturing v. distribution);
- Whether R&D activities are performed;
- Whether intangibles are used;
- Whether quality control activities are performed;
- Advertising and marketing;

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- Ordering and distribution;
- Invoicing and collection;
- Inventory management;
- Warranty activities; and
- Human resources.

Some of the risks that must be identified and reviewed include:

- R&D failure risk;
- Inventory risk;
- Product defect risk;
- Credit risk;
- Foreign exchange risk; and
- Product liability risk.

Comment: Acquiring this information requires a thorough review of the taxpayer's financial information, including annual reports, securities filings, and corporate minutes. In addition, questionnaires are often sent to relevant departments to collect information on their activities, and key personnel are interviewed. Currently, taxing authorities are, on audit, expanding the needs in a functional analysis to organization clients, personnel charts by job description and function and even compensation and bonus levels. Implied in these requests and substance versus form and profit shifting concerns.

.03 Identification of Comparable Transactions and Comparable Unrelated Entities

The next step of a Transfer Pricing Report is the selection of comparable transactions or comparable uncontrolled entities.

Comparable Transactions. The taxpayer's transactions with unrelated entities, if any, are reviewed to determine whether the CUP or CUT methods can be applied. In addition, the regulations allow for transactions between unrelated third parties to be used in a CUP or CUT analysis (this data is usually found in market or industry reports). In order to successfully apply the CUP or CUT method, the uncontrolled transactions must be sufficiently similar to the controlled transactions to provide a reliable measure of an arm's length result. Several factors to consider in evaluating comparable transactions include:

- Availability of competitor pricing information;
- The presence or absence of trademarks or tradenames;
- Level of the market (e.g., wholesale v. resale)
- Contract terms;
- Quantity and volume discounts;
- Geographic markets;
- Exchange rate risks;

- Whether available pricing information concerns transactions between unrelated parties; and
- Whether adjustments can be made to eliminate the pricing differences resulting from differences in the transactions.

The regulations allow a reasonable number of adjustments to the uncontrolled transaction to account for material differences between the controlled and uncontrolled transactions, if such differences have a definite and reasonably ascertainable effect on prices or profits. Recognizing the relative impossibility of obtaining exact comparables, the Tax Court created the "sufficiently similar" standard for determining whether an uncontrolled transaction is comparable to a controlled transaction.[28] Notwithstanding, asset intensity and ratio of operating expense to gross receipts adjustments are becoming commonplace.

Comment: The "inexact CUP" analysis has recently been applied by the Tax Court in a variety of contexts.[29]

Comparable Companies. While comparable transactions may exist between two entities unrelated to the tested party, reliable data and information about such transactions is exceedingly difficult to obtain. If adequate comparable transaction data cannot be found, whether from internal or external sources, it is necessary to conduct additional searches for companies with functional comparability. These searches are typically done using commercially available corporate information databases, such as Moody's, Standard and Poors, or Compustat, and are based on SIC codes.

The functional and risk analysis is used to develop and apply screening criteria to publicly available databases to identify potential comparable companies. Factors to be considered include whether the potential comparable company:

- Engages in similar business activities (e.g., distribution, manufacturing, etc.);
- Operates in the same geographic location;
- Operates in the same level of the market (e.g., wholesale v. retail);
- Underwent a major disruption to the normal course of business;
- Had significant related party transactions that could not be segregated;
- Assumes similar risks (e.g., warranty, credit, foreign exchange);
- Uses similar assets (e.g., intangibles, asset intensity); and
- Lacked sufficient data.

.04 Analysis of Comparables

Once the comparable companies are selected, their financial statements are reviewed and adjustments made to increase their reliability.

[28] *See Bausch & Lomb, Inc.*, CCH Dec. 45,547, 92 TC 525 (1989), *aff'd*, 91-1 USTC ¶ 50,244, 933 F.2d 1084 (2d Cir. 1991).

[29] *See GAC Produce Co.*, CCH Dec. 53,349(M), 77 TCM 1890, TC Memo. 1999-134 (marketing services); *Compaq Computer Corp.*, CCH Dec. 53,443, 78 TCM 20, TC Memo. 1999-220 (computer circuit boards); *H Group Holding, Inc.*, CCH Dec. 53,575(M), 78 TCM 533, TC Memo. 1999-334 (hotel group trade name).

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Segmentation of Financial Statements. The financial data of each comparable should be reviewed in order to separate out data that is not relevant to the transfer pricing analysis, such as:

- Sales to/from different geographic markets;
- Transactions with related parties; and
- Balance sheet assets dedicated to different operations (e.g., separating manufacturing assets from distribution assets).

Accounting Adjustments. The taxpayer and comparable companies' financial data may also need to be adjusted to eliminate the impact of different accounting practices. Examples of these adjustments include:

- Differences in income and expense recognition or classification;
- Characterization and depreciation of fixed assets;
- Characterization and amortization of intangible assets;
- GAAP differences;
- Restructuring charges;
- Characterization of leases; and
- Foreign exchange gains and losses.

Diagnostic Adjustments. Diagnostic ratios are also calculated to help determine whether a potential company is sufficiently comparable to the taxpayer. Some of these ratios include:

- Days inventory, payables, and receivables;
- Ratio of intangible assets to tangible assets;
- Ratio of current depreciation to accumulated depreciation; and
- Ratio of assets to sales.

Selecting the TPM. The next stage of a transfer pricing study is the selection and application of a TPM. The regulations require taxpayers to select a method that provides "the most reliable measure" of an arm's length result.[30] The regulations provide for the following TPMs:

- Comparable Uncontrolled Price Method ("CUP")—Reg. § 1.482-3(b);
- Resale Price Method "(RPM")—Reg. § 1.482-3(c);
- Cost Plus Method ("CP")—Reg. § 1.482-3(d);
- Comparable Profits Method ("CPM")—Reg. § 1.482-5; and
- Profit Split Method—Reg. § 1.482-6.

The selection of the most reliable TPM will ultimately depend on:

- The degree of comparability between the controlled and uncontrolled transactions;
- The quality of the data and assumptions used in the analysis;
- The completeness and accuracy of the data;

[30] Reg. § 1.482-1(c)(1).

- The soundness of the assumptions relied upon;
- The sensitivity of results to deficiencies in data and assumptions; and,
- Where two methods produce inconsistent results, the confirmation of the chosen results by comparison with a third method.

Although a detailed discussion of the TPMs is beyond the scope of this chapter (see Chapters 3 and 4), a brief discussion of each TPM, and their strengths and weaknesses follows.[31]

CUP. The CUP method is based on a direct observation of the prices charged in the market. However, because of the lack of publicly available data concerning external CUPs (i.e., comparable transactions between two unrelated parties), internal CUPs (i.e., comparable transactions between the taxpayer and an unrelated party) are often used. Nevertheless, if data is available to support the use of the CUP with appropriate adjustments, if necessary, then the use of the CUP method will almost always satisfy the best method rule.[32]

The CUP method is often difficult to apply in practice, however. Most of the problems encountered in trying to apply the CUP method involve finding transactions that are sufficiently comparable to the related party transaction being tested. These problems include:

- Differences in product quality;
- Differences in the level of the market;
- Differences in geographic markets;
- Limited publicly available information; and
- Differences in contractual terms;

RPM. The RPM, which is based on a comparison of gross margins, is typically applied to distribution companies. Application of the method, however, requires the use of comparable companies that have similar risks and that only have routine intangibles. Furthermore, adjustments must be made for functional differences such as:

- Advertising;
- Warranty;
- Product liability;
- Inventories;
- Scale of operations;
- Contract terms;
- Additional services performed; and
- Credit terms.

Cost Plus. The Cost Plus method is typically used for routine manufacturing (e.g., contract manufacturing) and service operations (e.g., contract R&D). The Cost Plus method is less often used for distributors, but a limited function distribu-

[31] *See* Chapter 3.

[32] Reg. § 1.482-3(b)(2)(ii)(A).

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tor may be treated economically as a mere service provider (e.g., freight forwarders). In applying the Cost Plus method, the comparable companies must have similar characteristics regarding the following:

- Functions, risks, and routine intangibles;
- Production processes;
- Cost structure; and
- Accounting consistency.

CPM. The CPM, which in practice is the preferred TPM in the United States, tests the taxpayer's operating income as a proxy for testing transfer prices. As such, it is most useful when the other TPMs cannot be applied because of a lack of adequate data. The use of the CPM is dependent on functional comparability and not product comparability. Although CPM is not officially recognized by several of the United States' major trading partners (because of its departure from transactional methods), variations of the CPM have been applied to their satisfaction.

Profit Split. The profit split method allocates shares of the groups' total profits based on the relative value of each party's contribution. The value of contributions are determined by applying a functional analysis. The profit split method is usually used in very complex intercompany relationships when one of the following conditions is satisfied:

- No other TPM can be successfully applied;
- Vertically integrated companies have achieved profitability substantially in excess of non-integrated firms; or
- Unique intangibles are embedded in the transfer price.

Transactional v. Profits-Based Methods. As a practical matter, taxpayers are unlikely to have access to reliable data on external comparable transactions, assuming they exist. Therefore, the use of transactional methods will depend on the existence of internal comparable transactions. Experience has shown that internal comparable transactions rarely exist, and when they do, they often require significant adjustments to account for differing markets, terms, and risks. In addition, small differences in the pricing of potential internal transactional comparables can lead to significant differences in profits, making such methods overly sensitive to deficiencies in data or necessary adjustments.

Deficiencies in transactional methods frequently lead to the use of a profit-based method such as a profits based resale price method or the CPM. Due to the difficulties in using transactional methods and the IRS' experience with CPM, both taxpayers and the IRS generally rely on the CPM as the method of choice. Although nearly all countries other than the U.S. explicitly reject the CPM approach, a number of cases developed pursuant to a CPM approach have been resolved through the APA process. Taxpayers generally demonstrate the results under the primary TPM employed by each involved country to facilitate competent authority discussions.

Selection of Profits-Based Profit-Level Indicators ("PLIs"). If a profits-based CPM is used, then an appropriate PLI must be selected. Although the

regulations only specify three PLIs, return on capital ("ROC"), operating margin, and the Berry Ratio, other PLIs, such as gross margins, have been applied. Nevertheless, these three PLIs, or variations thereof, are the ones most used in practice.

> ***Comment:*** When a taxpayer is under audit, the choice of PLI can often make the difference between a substantial adjustment with penalties and no adjustment.[33]

Each PLI has its own strengths and weaknesses. For instance, the use of the ROC as a PLI can be based on the economic theory that similar firms operating in a competitive environment will earn similar returns on their capital. In addition, the ROC PLI is often more reliable than the Berry Ratio or Operating Margin when there are functional differences between the taxpayer and the comparable companies. However, its use is hampered by its reliance on balance sheet information, which may not properly reflect the true amount of capital employed. Similarly, operating margin, and berry ratio PLIs are sensitive to different levels of operating expense to sales ratios.

.05 Applying the TPM to the Facts

If the CPM is selected as the best method, then the interquartile range is calculated and compared to the taxpayer's results. If the taxpayer's results are below the interquartile range, then a compensating adjustment will likely be necessary.

¶ 1060 Satisfying Multiple Jurisdictions

.01 Background

During the 1980s and 1990s, the United States spent considerable effort to modernize its transfer pricing laws and enhance the IRS's ability to enforce those laws. These changes were both substantive (enacting the commensurate-with-income standard and finalizing the regulations under Code Sec. 482) and procedural (enactment of penalties and documentation requirements). These changes are now allowing the IRS to better enforce Code Sec. 482 and the arm's length standard, thus making the costs of non-compliance prohibitive. Because transfer pricing can be a zero-sum game, any income shifted to the United States must ultimately reduce the amount of income subject to tax in other tax jurisdictions. Other countries, concerned that U.S. statutory and regulatory changes encourage taxpayers to shift income to the United States, are implementing similar legislation, enforcement, and penalty approaches. Consequently, taxpayers must be prepared to defend their transfer pricing practices on a global basis.

.02 Transfer Pricing Penalties and Documentation Goes Global

Like the United States, many foreign countries are relying upon the combination of transfer pricing penalties and documentation requirements to encourage taxpayers to comply with transfer pricing laws and to cooperate with transfer

[33] *See* Richard A. Clark, "Choosing a Reliable Profit Level Indicator," 5 *Tax Mgmt. Transfer Pricing Rep.* 25 (1997) for a discussion of applying the various PLIs.

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pricing examinations. These countries include almost all of the United States's major trading partners, including: Australia, Belgium, Canada, China, France, Germany, Korea, Mexico, the Netherlands, and the United Kingdom. This global emphasis on transfer pricing has forced taxpayers to manage transfer pricing exposure on a global basis. Consequently, documentation should be prepared to defend transfer pricing to the local tax authorities while simultaneously facilitating global compromise with other tax authorities; the ultimate goal being to avoid lengthy/expensive controversies and double taxation.

.03 Strategies for Multiple Jurisdictions

Factual Development. The first step in preparing transfer pricing documentation that satisfies multiple jurisdictions is to conduct a thorough analysis of the relevant facts. This would include function (e.g., manufacturer v. distributor, full-service distributor v. stripped distributor) and risk (e.g., entrepreneurial service provider v. contract service provider) analysis of each of the related parties, as well as an examination of the contractual provisions and economic conditions under which each entity operates. It is critical that this analysis be accurate and consistently presented, as any inaccuracies or differences in presentation will be the source of a considerable amount of controversy with the local tax authorities.

Reconciling Economic Analysis. Although many countries have enacted or are currently considering similar transfer pricing methodologies, most have explicitly rejected the CPM approach favored by the United States. Even if most of the major trading partners agreed on acceptable methods, the risk remains that examiners in the various countries would nonetheless interpret and apply those methods inconsistently. These differences (both substantive and administrative) place taxpayers at a higher risk of double taxation.

To satisfy the inconsistent TPM positions of multiple countries, taxpayers must reach a consistent result by making adjustments to the TPMs favored by the involved countries. Many taxpayers are able to reach this result by making appropriate economic adjustments to the applicable transfer pricing methodologies to make them more acceptable to foreign tax authorities. This has resulted in the creation of "hybrid TPMs" that can be accepted by multiple tax jurisdictions.

For instance, a U.S. documentation report that relies on the CPM application of the operating margin PLI as the best method can be reconciled with a Japanese documentation report relying on the resale price method by backing out SG&A expenses. Similarly, the CPM method preferred by U.S. taxpayers can be reconciled with foreign rules requiring the use of transactional methods by aggregating economically similar transactions.

Other taxpayers may be unable, or may find it difficult, to adjust the application of competing TPMs to achieve a consistent result. These taxpayers may ultimately need to seek competent authority assistance to avoid double taxation.

.04 Competent Authority

Despite a taxpayer's efforts to prepare global transfer pricing documentation, it could still be exposed to double taxation if one country proposes adjustments that

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are not accepted by the other countries. In situations where the application of United States and foreign tax laws would result in the taxpayer being subject to double taxation, a taxpayer may invoke a tax treaty's competent authority (mutual assistance) procedure to request relief from double taxation. Through the competent authority process, the U.S. and foreign government will negotiate a settlement to prevent double taxation. A settlement can take the form of one country withdrawing its adjustment, the other country making a correlative adjustment, or a combination of the two. The competent authority process is described more fully in Chapter 18. Although competent authority successfully resolves nearly all double taxation cases, taxpayers may find the competent authority process unsatisfactory due to the time required for resolution and the limited taxpayer involvement in the process.

.05 Advance Pricing Agreements

An alternative to preparing documentation that satisfies multiple jurisdictions is to negotiate either a bilateral or multilateral APA. An APA now called Advanced Pricing Mutual Agreement ("APMA") Procedures under the reorganized program (see Chapter 14) is a binding, written contract between the taxpayer, the IRS, and a foreign tax authority. In an APMA, the parties agree on the TPM for determining the arm's length price for certain covered transactions and the proper application of such method to the taxpayer's particular facts and circumstances. Once an APMA is finalized and executed by the parties, the IRS and the foreign tax authority will regard the results of applying the TPM as satisfying the arm's length standard provided the taxpayer complies with its terms. Although the approaches discussed in this section would likely be applied in negotiating the APMA to the satisfaction of each of the parties, such negotiation will cover multiple future years and facilitate future settlements of potential transfer pricing disputes. The APMA process is described in detail in Chapter 14.

For more on preparing transfer pricing documentation, see the Practice Tools at ¶ 20,070.

¶ 1070 Considerations and Issues Global Documentation

.01 Background

With the substantial efforts of the above countries and globally related organizations to establish precise documentation requirements, there is no question in today's environment that an MNC must design a consistent, cogent, and economically benchmarked global transfer pricing policy. An MNC's transfer pricing position is enhanced measurably with such documentation. Moreover, the increased focus in recent years on the role of transfer prices in a tax efficient structure means that an increasing number of MNCs have developed, on a global or regional basis, comprehensive transfer pricing systems. MNCs therefore increasingly have in their possession policies, strategic analyses, and documents that address transfer pricing in the context of either tax planning, management and/or commercial objectives. The question is first whether MNCs should present these policies, analyses, or documents (hereinafter sometimes referred to as "global documentation"), in either present or redacted form, to a tax authority as compliance documentation, assum-

Chapter 17

State Transfer Pricing

Overview . . . . ¶ 1701
Underlying Concepts . . . . ¶ 1710
Authority to Reallocate Income . . . . ¶ 1720
Income Allocation Issues and Approaches . . . . ¶ 1730
Recent Developments (and Potential Future
  Developments) . . . . ¶ 1740
Summary . . . . ¶ 1750

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¶ 1701 Overview[1]

Currently, 47 states plus the District of Columbia impose some sort of tax based on periodic business results.[2] While not all of the taxes are called corporate income or franchise taxes (and indeed, several of them reflect neither the GAAP definition nor the U.S. federal income tax definition of "net income"), the tax levy in each case is a function of a tax rate applied to a tax base.[3] The tax base, in turn, is determined by a formula based on gross business receipts with certain modifications. For purposes of this chapter, the tax base will be referred to as "taxable income."

Whether transfer pricing is relevant in these states depends on the filing methodology employed by the state. In general, states either require members of a unitary business group to file some form of combined or consolidated return ("combined reporting states") or on a separate company basis ("separate return states"). In combined reporting states, transfer pricing reports generally are not germane because intercompany transactions are eliminated, but on occasion may be beneficial (e.g., between two related but separate unitary groups in California).[4] In separate returns states, however, transfer pricing is more relevant and may play a key role in determining a taxpayer's tax liability.

[1] The authors would like to express their thanks to Darrell Coppin, Rebecca Bertothy, Marc Speer, and Scott McShan of Ernst & Young LLP for their assistance in the preparation of this chapter.

[2] All states except Nevada, South Dakota and Wyoming.

[3] E.g., Washington Business and Occupation Tax, Ohio Commercial Activity Tax, New Hampshire Business Profits Tax, etc.

[4] States with mandatory combined or consolidated return filing requirements are: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York State and City (only if significant intercompany transactions), North Dakota, Ohio (for CAT and only if consolidated filing is not elected) Oregon, Texas, Utah, Vermont, West Virginia, and Wisconsin. Note, other states may allow, or force, the use of combined/consolidated filing.

In separate return states, the impact of related party transactions may be greater on state tax returns than on federal returns,[5] for two main reasons:

1. Every cross-border transaction that originates, terminates or otherwise involves operations in the United States will impact the taxable income of one or more entities in the involved Federal consolidated group, however;
2. Domestic transactions between members of the group will generally not be considered when calculating the taxable income of the group.

Even though transfer pricing, as a concept, in separate return states has at least as large a role in determining state taxable incomes as it does in determining federal taxable income, as a discipline and as a point of controversy, it has not enjoyed the same high profile among state taxpayers and taxing authorities as it has at the federal level. Taxpayers have historically expended less energy to document transfer pricing policies at the state level, and states have provided little or no guidance about what is required.

Further, states have generally not focused audit efforts on transfer pricing, *per se*. And while transfer pricing has been a point of litigation in a handful of state tax cases (mainly out of New York), few cases have turned on the competency or timeliness of transfer pricing documentation. Other reasons for the relatively low profile of transfer pricing at the state level as compared to the federal level, include differences in tax systems, authority and available remedies. These differences will be discussed in subsequent sections, along with relevant, exemplary cases of tax litigation. This lack of attention to state transfer pricing, however, may be and, in fact, seems to be yielding to at least some attempt on the part of states to develop their approaches to transfer pricing and we will likewise address these developments and some possible reasons for them.

¶ 1710 Underlying Concepts

To understand the state approach to income allocation, and especially to dealing with perceived misallocations of income, several concepts must be explained.

.01 Taxable Income

In most states that levy a tax based on net income, the starting point for calculating state taxable income is Federal taxable income. For related affiliates that are members of a single Federal consolidated filing group, there is a single calculation of Federal taxable income for the group. The Federal taxable income for each corporation is calculated on a pro forma basis, as if it was going to file a separate Form 1120, and then in each state certain adjustments are made. On a *pro forma* basis, intercompany transactions are considered, and affect taxable income unless and until consolidations occur.

[5] Where the difference in effective tax rates between the U.S. and other countries, the impact of related party transactions often times is much greater than the impact on state rates.

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.02 Allocable Income

After determining each member's share of Federal taxable income, those members doing business in, and considered to be taxpayers in, multiple states must further allocate taxable income to the respective states in which they file. The term "allocable income" is used when describing the income of a multistate tax filer that is attributable to only one state. An example of allocable income is the gain on the sale of non-business real property.

.03 Apportionment

After determining an entity's share of Federal taxable income and allocating any portions of that share that are not attributable to interstate commerce, the remainder is divided among the various states in which the taxpayer does business. This is accomplished by applying a formulary *apportionment* methodology to the total remaining, or *apportionable* income.

States employ a variety of apportionment formulas, but all are based on some ratio of business attributes. Although many states use the Uniform Division of Income for Tax Purposes Act (UDITPA) three-factor apportionment formula consisting of equally-weighted payroll, property and sales factors,[6] many states use a modified three-factor apportionment formula that assigns more weight to the sales factor than the other two factors. Some of these states assign a double weight to the sales factor, i.e., 50 percent sales, 25 percent property, 25 percent payroll.[7] However, several states have adopted other variations in this formula.[8] Further, a recent trend has led to several states adopting a single sales-factor apportionment formula.

.04 Arm's Length Standard/Arm's Length Doctrine

As in the general body of transfer pricing knowledge, the *Arm's Length Standard* requires that transactions between related parties be consummated at prices and under terms that are as close as possible to those of transactions between unrelated parties.

.05 Distortion

Distortion simply means that income reflected on a taxpayer's state income tax return is distorted, or inaccurate, due to intercompany transactions included in the results. As we shall discuss below, until January 1, 2007, the New York State Tax Code provided that the presence of significant intercompany transactions creates a rebuttable presumption of distortion, with the burden of proof being on the taxpayer. As a point of definition, the presumption of distortion necessarily includes a presumption that transactions are not at arm's length.

[6] States that use an equally weighted three-factor apportionment formula include: Alabama, Delaware, District of Columbia, Hawaii, Kansas, Montana, New Mexico, North Dakota, and Rhode Island.

[7] Corporate income tax states that utilize a double-weighted sales factor apportionment formula include: Arizona, Arkansas, California, Florida, Idaho, Kentucky, Louisiana, Maryland, Massachusetts, New Hampshire, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Vermont, Virginia, and West Virginia.

[8] States that have adopted or are phasing-in a single sales factor include: Colorado, Connecticut, Georgia, Illinois, Indiana, Iowa, Maine, Michigan, Minnesota, Nebraska, New York, New York City, Oregon, South Carolina, Texas, Utah, Washington (B&O tax purposes) and Wisconsin.

.06 Economic Substance Doctrine

The economic substance doctrine is inclusive of the concept of *business purpose* and requires the application of a two-pronged test to a related party transaction:

1. the subjective intent of the taxpayer entering into the transaction—is there a motive (i.e., a profit motive) beyond that of saving federal taxes (a "non-tax business purpose"), and
2. the objective economic substance of the transaction; was there actually a substantive economic impact from the transaction (beyond the impact of reducing federal taxes).

It should be noted that the use of the connector "and" predated the actual codification of the economic substance doctrine. Prior to the enactment of Code Sec. 7701(o), the economic substance doctrine generally was considered to turn on *either* a non-tax business motive *or* actual substantive non-tax economic impact.

When states apply the economic substance doctrine, the term "state" is substituted for "federal," and transactions must be seen to have a non-state-tax business purpose and a non-state-tax economic effect. For instance, under Wisconsin law, a transaction will have economic substance, if all of the following are met: (1) the transaction changes the taxpayer's economic position in a meaningful way, apart from federal, state and foreign tax effects; and (2) there is a substantial nontax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing the substantial nontax purpose (i.e., the transaction has substantial potential for profit, disregarding any tax effects). Transactions between members of a controlled group will be presumed to lack economic substance. Taxpayers can rebut the presumption by establishing by clear and convincing evidence that a transaction or series of transactions between the taxpayer and one or more members of the controlled group has economic substance.[9]

.07 Sham Transaction Doctrine

The sham transaction doctrine is to be viewed as a threshold issue that should be considered even before the application of the economic substance doctrine. The sham transaction doctrine refers to transactions that do not in fact occur as purported. An example of a sham transaction is a transaction in which certain income is attributed through accounting entries to one entity, while the transactions giving rise to the income are wholly attributable to another entity.

The sham transaction doctrine is essentially about the lack of economic activity, while the economic substance doctrine refers to a lack of economic result. However, many make little distinction between the two, and in fact the doctrines are often used interchangeably.

.08 Nexus

The first step in defining the taxable income of a particular taxpayer is determining "who is a taxpayer?" A threshold issue is the determination of "nexus."

[9] Wis. Stat. §§71.10, 71.30, and 71.80.

For purposes of this chapter, we will simplify the definition of nexus to be: "The right of a state to require a taxpayer (however that is defined in each state) to file an income tax return and pay a tax measured by net income."[10]

Some states employ a "nexus combined" theory for determining which related entities are included in the consolidated state tax return. Under that concept, only those entities with nexus in the state are included as members of the group.

¶ 1720 Authority to Reallocate Income

Generally speaking, if the allocation of income between related parties has an impact on a state tax return, that state will have some statutory authority to reallocate income if it perceives a misallocation. The state's authority to reallocate may be found in various statutory provisions, including the following.

.01 Incorporation of Code Sec. 482

Reg. § 1.482-1(a)(2) gives the IRS authority to make allocations among taxpayers:

> The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

Many states incorporate the IRC, including section 482, by reference. While some states have interpreted this to mean they have the authority to make adjustments to intercompany pricing, others believe that the specific references to "the district director", "controlled group" and "controlled taxpayer" limits the application of Code Sec. 482 to federal taxpayers.[11]

.02 UDITPA Section 18

In 1959, the National Conference of Commissioners on Uniform State Laws approved a model statute for the allocation of income resulting from interstate operations, known as the Uniform Division of Income for Tax Purposes Act, or UDITPA. UDITPA set out formulae and standards for determining the respective state taxable incomes for companies doing business in multiple jurisdictions. However, UDITPA also recognized that the formulae and standards may need to be supplemented by further analysis in certain cases. In order for adoptees to retain the flexibility to deviate from the standard approach, a final section was added.

> Section 18: If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

[10] In February 4, 2010 testimony to the Congressional Subcommittee on Commercial and Administrative Law, Professor Walter Hellerstein stated: "In the state tax context, nexus generally means the connection that a state must have with a person, property, transaction, or activity in order for a state to exercise its taxing power constitutionally over such person, property, transaction, or activity."

[11] States that have adopted 482-type provisions include: Alaska, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Florida, Georgia, Hawaii, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Minnesota, Mississippi, Montana, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Oklahoma, Oregon, Tennessee, Texas, Utah, Virginia, and Wisconsin.

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(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of *any other method* to effectuate an equitable allocation and apportionment of the taxpayer's income. (emphasis added)

Subsequent to the adoption of UDITPA, the Multistate Tax Commission (MTC) approved allocation and apportionment regulations, to provide guidance with respect to when an alternative method of apportionment may be required or permitted.

The very general authority granted in paragraph (d) of Section 18 likely gives adopting states the authority to adjust the price of intercompany transactions, even where they do not incorporate Code Sec. 482 or do not believe Code Sec. 482 applies to transactions at the state level. Over 30 states adopted provisions similar to UDITPA Section 18 and MTC Article IV.18.[12]

.03 Other General Authority

Even without the other points of authority discussed in this section, most states have given their executives broad authority to make adjustments to "accurately reflect" a taxpayer's taxable income within the state. Generally, then, states have the authority to seek remedy when it appears that a transaction between related parties has been conducted at an other than arm's length price, resulting in excess deductions for the in-state taxpayer.

What is lacking, in most cases, are detailed directions for the application of transfer pricing principles, as provided in Reg. § § 1.482-2 through 1.482-9. This is true if the relied upon authority is the UDITPA Section 18, or a more general authority. Only New Jersey has promulgated regulations controlling the application of transfer pricing principles to specific taxpayer situations.[13]

¶ 1730 Income Allocation Issues and Approaches

.01 Need for Transfer Pricing Documentation

As noted, distortion is often presumed when a substantial number of intercompany transactions are transacted and, in such cases, it is the taxpayer's burden to rebut the assumption. As stated earlier, the presumption of distortion is inclusive of a presumption that the pricing of the underlying transactions, in whole or in part, are not at arm's length. In such cases, the common and logical approach is for the taxpayer to present evidence that the transactions *are* at arm's length.

While there is little regulatory or statutory guidance regarding the form of such evidence or the standards to apply, the approach most commonly taken is the application of Reg. § § 1.482-2 through 1.482-9.

[12] States adopting UDITPA section 18, MTC Article IV.18, or other similar provisions include: Alabama, Alaska, Arizona, Arkansas, California, Colorado, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Maine, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, and Virginia.

[13] N.J. Admin. Code § 18:7-5.10.

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Under these circumstances, and even though few states require such documentation, the prudent taxpayer documents his or her transfer pricing policies and methods. Documentation is likely to be the first line of argument in rebutting the presumption of distortion, and the first line of defense against other arguments regarding the arm's length nature of intercompany transactions. In New York, for instance, the fact that a Code Sec. 482 compliant transfer pricing study was prepared by the taxpayer shifts the burden of proof from the taxpayer to the state.

While the timely preparation of competent transfer pricing documentation is a prudent precaution, taxpayers must be aware of the limitations of the protection offered by such documentation. While states have penalty provisions that could be levied for failure to maintain adequate transfer pricing documentation (for instance, a "good faith" penalty or an inaccuracy or underreporting penalty), there currently are no penalties specifically enacted to that effect. Likewise, states are unlikely to rely on a single doctrine when mounting an attack. As we will see, rather than a threshold issue, the arm's length doctrine is often the final and conclusory issue argued.

.02 The States' Approach: Application of Doctrines

While the *arm's length doctrine* is available to many states and may, if properly applied, produce the desired result, states have other options available and have shown some preference for the broader brush approaches of applying the *sham transaction doctrine* and the *economic substance doctrine*. In any case, the goal of the audit is to increase the income subject to the state's tax.

A Hierarchy of Doctrines. Donald Korb (former Chief Counsel for the IRS) has advocated a hierarchical approach to applying the sham transaction doctrine and the economic substance doctrine. He called the sham transaction test a "threshold" issue to be considered first and to be followed by applying the economic substance doctrine. The reason for establishing this hierarchy is readily apparent: conservation of effort. It is easier to determine if economic activity actually took place than it is to determine if the activity resulted in a substantial change in economic conditions. If a transaction fails the first test, there is no need to proceed to the more difficult (and more costly) second test.

Likewise, state taxing authorities have pursued a hierarchy of doctrines in auditing intercompany transactions. As demonstrated by some of the cases analyzed below, the arm's length standard can be added to that hierarchy as the final and most difficult doctrine to argue.

.03 Arguing Multiple Theories

While the logical development and consideration of the three doctrines—Sham transaction, economic substance and arm's length—may be hierarchical in nature, states often argue them simultaneously as multiple theories in the same audit. In this context, we consider the *Syms* case out of Massachusetts.[14]

[14] *Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505 (2002).

Syms, a New Jersey based "off-price" retailer, operated stores in the state of Massachusetts. Syms filed and paid the Massachusetts corporate excise tax (a tax measured by net business income). In 1986, based on the recommendations of an outside state tax consultant, Syms formed a subsidiary corporation, SYL, to which it contributed its intellectual property ("IP") which consisted of the Syms name, a trademarked logo and a copyrighted slogan. Thereafter, Syms paid SYL a royalty for the use of the contributed IP, equivalent to 4% of Syms' retail sales, pursuant to a licensing agreement with SYL.

After entering into the royalty agreement with SYL, Syms deducted from its Massachusetts excise tax return the amounts it paid to SYL, significantly lowering its Massachusetts tax liability. SYL was a Delaware corporation, with no operations in Massachusetts. SYL was not subject to the Massachusetts excise tax, and it also was exempt from the Delaware corporate income tax. Thus, the income received by SYL effectively escaped taxation.

In an audit of the tax years 1986 through 1991, the Massachusetts Commissioner of Revenue disallowed the deductions taken by Syms for the royalty expenses paid to SYL. Syms protested the audit and proceeded to an evidentiary hearing before the Appellate Tax Board. The Board found that the Commissioner had property disallowed the expenses because:

(1) the transfer and leaseback of the marks was a sham and could be disregarded under the "sham transaction doctrine";

(2) the royalty payments were not deductible as ordinary and necessary business expenses where there was no valid business purpose justifying the expense and SYL added little or no value to the marks; and

(3) *M.G. L. c. 63, §39A*, permitted the commissioner to eliminate the royalty payments from the calculation of net income because they were made between affiliated corporations and were in excess of fair value.

All three of the doctrines we defined earlier (sham transaction, economic substance and arm's length) were pursued by the Commissioner and confirmed by the Board. It is worth noting that the definitions extended to the sham transaction doctrine by the Board vary somewhat from what has been previously discussed. In this case, the Board defined a "sham transaction" to mean a transaction that in fact occurred in an effort to exploit a feature of the tax laws, not a transaction that did not occur, or did not occur as reported.

In essence, the Board applied the sham transaction and business purpose doctrines together in these proceedings.

Syms appealed to the Supreme Judicial Court of Massachusetts, where the finding of the Board was upheld.

Interestingly, even though the arm's length nature of the transactions was disputed by the Commissioner, and the Board agreed, no evidence was presented on that point. In fact, though the Board found the intercompany transactions to be ". . . in excess of fair value . . ." it reasoned that the "circular" nature of the transaction made it ". . . irrelevant that the measure of royalty payments might have been equivalent to what would have been paid in an arm's-length transaction."

The results of the *Syms* case are to be contrasted with those of the *Sherwin-Williams* case.[15] These two cases were decided in the same year, both by the Massachusetts Supreme Judicial Court and both appear to have very similar facts and circumstances. The outcomes, however, were very different.

Sherwin-Williams is an Ohio-based manufacturer and seller of paint and related products. In 1990, Sherwin-Williams began to evaluate a plan for the management of valuable IP. In 1991, a wholly owned subsidiary was formed and valuable IP, including the name "Sherwin-Williams," various other trade names and trademarks and slogans were contributed to this new subsidiary, Sherwin-Williams Investment Management Company, Inc. ("SWIMC"). A similar transaction was separately transacted to create Dupli-Color Investment Management Company, Inc. ("DIMC"), which held the IP for the Dupli-Color line of business.

After contributing the IP, Sherwin-Williams paid a royalty to SWIMC, and deducted the royalty payments from its Massachusetts excise tax return, thereby reducing its Massachusetts excise tax expense. SWIMC, a Delaware corporation, was not a Massachusetts taxpayer and, similar to SYL, was exempt from the Delaware corporate income tax.

To this point, the facts and circumstances of Sherwin-Williams (even the early history of the case) appear to be similar, if not identical, to those in *Syms*. The Commissioner disallowed the royalty expenses paid by Sherwin-Williams to SWIMC, arguing the same three theories:

(1) the transfer and license back of the marks was a sham and could be disregarded under the "sham transaction doctrine";

(2) the royalty payments were not deductible as ordinary and necessary business expenses when there was no valid business purpose justifying the expense; and

(3) M.G. L. c. 63, §39A, permitted the commissioner to adjust the taxable income of Sherwin-Williams by eliminating the royalty payments because they were not made at arm's length and distorted the actual income of Sherwin-Williams.

In this case, however, the outcome was significantly different. On every point, the Court disagreed with the Commissioner and the Board, holding that the transactions were not a sham and had a valid non-tax business purpose and economic substance. Much was made of the documented efforts on the part of management to explore, with outside counsel and other experts, the business and legal advantages of separately owning the IP.

With regard to the price paid by Sherwin-Williams to SWIMC for the license, the Commissioner argued that the transactions were not at arm's length because of the nature of the relationship between the entities; therefore, any payments made had to be in excess of "fair value." Interestingly, the Court agreed that the transactions were not "arm's length" (presumably because Sherwin-Williams controlled SWIMC and, as in *Syms*, the transactions were circular in nature), but agreed with Sherwin-Williams that fair value was established by the valuation study

[15] *Sherwin William v. Massachusetts*, 438 Mass. 71 (2002).

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done by a third party consultant. The merits of the study were not argued, and indeed one of the Commissioner's experts testified: "If [the Sherwin-Williams's marks] were owned by an independent third party . . . a stranger . . . chances are that a very high royalty would be paid."

It should be noted that the Commissioner relied on his authority under Mass. G.L. c. 63, § 39A, which is a "fair value" test, rather than his presumed authority under Code Sec. 482 which requires the transactions be at arm's length. Perhaps if the Commissioner had made the arm's length argument, the circularity of the transaction would have resulted in a different verdict.

Since there was no argument or evidence presented regarding either the fair value or the arm's length nature of these transactions, one cannot say that this case was decided on the question of transfer pricing or economics, but one may infer that without the competent valuation and royalty study, the taxpayer would have failed to sustain its position. The transfer pricing documentation, such as it was, was a necessary but partial requirement to successfully sustaining the taxpayer's position.

.04 Alternative Remedies

At the federal level, the remedy most applied when intercompany transactions are found to be not at arm's length is an adjustment of the transfer price. In *Syms* and in *Sherwin-Williams*, the Commissioner sought to deny the entire deduction for the intercompany royalties paid, under authority granted by Mass. G. L. c. 63, § 39A. As made clear by the court in Sherwin-Williams, § 39A granted the authority to deny deductions "... only to the extent that such payments are in excess of fair value ..." In essence, § 39A granted the commissioner the authority to adjust the price, and in these two cases the intended adjustment was 100 percent of the deduction.

While price adjustments are available to some state taxing authorities, many also have alternative remedies available. In the last twenty years, the most commonly applied alternative remedy is "forced combination", the use of which exceeds pricing adjustments in its incidence.

Forced combination occurs when a taxpayer is required to file a combined state tax return with a non-taxpayer, even though the default filing method in the state is separate company. The difference in result between a 100 percent price adjustment (as in *Syms*) and forced combination is that the tax attributes of the non-taxpayer may be combined with the attributes of the original taxpayer. These attributes include the entire taxable income of the non-taxpayer, as well as the apportionment factors. To the extent the non-taxpayer does business with third parties or affiliates other than the taxpayer, the taxpayer's apportionable taxable income is increased to a greater extent than if the transaction were merely adjusted, even if the adjustment is 100 percent.

Just as we discussed in the earlier cases, the application of the forced combination remedy may be made in cases where the key issue in controversy is the arm's length nature of intercompany transactions, but it is more likely that a state taxing authority will argue multiple theories, just as in *Syms* and *Sherwin-Williams*.

Unsurprisingly, a taxpayer's facts may attract the attention of more than one state. Ironically, the same facts may result in different results based on the doctrine applied by the state. Such was the case for Sherwin-Williams.

In 2004, two years after the Massachusetts decision, Sherwin-Williams argued the same facts before the New York Appellate Court.[16] At the time, New York State employed a separate company filing method. However, the statute in effect at the time provided that substantial intercorporate transactions created a rebuttable presumption of distortion.[17]

While the primary argument made by the New York Department of Taxation and Finance ("DTF") was that Sherwin-Williams had failed to rebut the presumption of distortion, the underlying reasoning was similar to the arguments by Massachusetts, save one: the DTF did not claim that the intercompany transactions were sham transactions. Rather, the DTF argue that the transactions were without a valid business purpose, lacked economic substance, and were not at arm's length. Since Massachusetts effectively combined the sham transaction and business purposes/economic substance arguments into a single argument, the rationale employed in this case *is* functionally equivalent to that argued by Massachusetts.

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While the arm's length arguments were made by each side, the New York court focused almost entirely on the business purpose/economic substance arguments, merely noting the positions of the taxpayer and the DTF (and their outside experts). Ultimately, the Court found that the DTF had the authority to force combined Sherwin-Williams with SWIMC and DIMC because the transactions lacked economic substance and business purpose.

Both the direction of the arguments and the results of the cases discussed above provide a clear view of the hierarchy of doctrines noted earlier. In each case, the sham transaction and economic substance/business purpose doctrines were considered (albeit as a single analysis, rather than separately) before the arm's length nature of the transactions were considered. Where the case turned on the sham transaction/economic substance analysis, little attention or weight was given to the arm's length arguments.[18]

There are several reasons that explain why the arm's length doctrine is subordinated to the others: (1) states have considerably fewer resources at their disposal to consider the arm's length nature of transactions; (2) the arm's length determination may change over time; and (3) the arm's length standard does not lend itself to a single answer, but rather a range of considerations.

[16] *Sherwin-Williams Co. v. New York Tax Appeals Tribunal*, 830 N.E.2d 320 (2005).

[17] See 20 NYCRR 6-2.3 [a] [b]. It should be noted that effective January 1, 2007, for purposes of New York State franchise tax on general business corporations and on insurance corporations, New York law requires related corporations file a combined report that covers any related corporations if there are substantial inter-corporate transactions among the related corporations, regardless of the transfer price for such inter-corporate transactions. This change eliminates the rebuttable presumption of combination due to intercompany transactions; however, the Commissioner still has the authority to seek to compel combination where the requisite intercompany transactions are lacking.

[18] *See also In the Matter of the Petition of Talbots, Inc.*, No. 820168 (N.Y. Tax App. Trib. Sept. 8, 2008) (because there was substantial evidence to support the finding that the arrangement lacked economic substance and a valid business purpose, the Tribunal did not find it necessary to address whether the royalty rates reflected market rates).