US Transfer Pricing: Basic Rules

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This Note provides a general overview of US transfer pricing rules, and focuses on the relevance of US transfer pricing rules to cross-border transactions among related entities.

US federal transfer pricing rules are often a key tax concern for multinational groups. The US federal transfer pricing rules have primary relevance for:

- Multinational companies that engage in cross-border transfers of goods, services, capital, intangible property, and risks among related entities which include US entities. This can include transactions between:
  - A US parent and a non-US subsidiary.
  - A foreign parent and a US subsidiary.
  - Commonly controlled brother-sister companies.

- US companies that transfer goods, services, or property between related US entities, if these entities do not file a US consolidated federal income tax return.

In the case of transactions between a related US and non-US entity, the consequences of a transfer pricing adjustment by the IRS can be severe and in certain circumstances can result in double taxation (see Failure to Address Transfer Pricing Issues Can Result in Double Taxation).

This Note provides a general overview of US federal transfer pricing rules, focusing on the relevance of US transfer pricing rules to cross-border transactions among related entities. This Note does not discuss non-US transfer pricing rules or transfer pricing issues under state tax law.

What is Transfer Pricing?

Transfer pricing is the amount charged for goods, services, capital, intangible property, or risks transferred between related companies. When related companies sell goods or services to each other or transfer property, there are no market forces to determine the prices charged. Transfer pricing rules address the lack of market prices in related party transactions and attempt to prevent the inappropriate shifting of income to low-taxed jurisdictions.

For example, assume US Parent, a holding company, owns 100% of US Subsidiary, a US corporation subject to a 21% US federal income tax rate, and 100% of Foreign Subsidiary, a corporation subject to a 15% corporate income tax rate. US Subsidiary manufactures engines, which it sells to Foreign Subsidiary. Foreign Subsidiary resells the engines to customers in Europe for $100,000 per engine. If US Subsidiary charges Foreign Subsidiary $80,000 for each engine and sells ten engines to Foreign Subsidiary during the year, the $800,000 earned by US Subsidiary is subject to a US federal tax of $168,000, assuming no deductions (0.21 times $800,000). Foreign Subsidiary is subject to a 15% corporate income tax on $200,000 ($1,000,000 aggregate selling price less $800,000 cost of goods sold), for a tax of $30,000. The total worldwide tax paid by the US Parent group is $198,000 ($168,000 plus $30,000).

If US Subsidiary instead sells each engine to Foreign Subsidiary for $50,000, the worldwide tax paid by the US Parent group for the year decreases. US Subsidiary is subject to US federal income tax of $105,000 (0.21 times $500,000) and Foreign Subsidiary is subject to a 15% tax on $500,000 ($1,000,000 aggregate selling price less $500,000 cost of goods sold), for a tax of $75,000. The total worldwide tax paid by the US Parent group is now $180,000 ($105,000 plus $75,000).

In the absence of any transfer pricing rules, US Subsidiary would generally be free to set the price for engines sold to Foreign Subsidiary at an amount that reduces the US Parent group's aggregate worldwide tax. However, in some cases there may be less incentive to shift profits outside the US given the lower 21% US federal corporate income tax rate introduced by 2017 tax reform.

Typical Intercompany Transactions

Related entities within a multinational group may engage in many different types of cross-border transactions. Some of the most common cross-border transactions are:

- Sales or leases of tangible property.

- Provision of services, including back office and administrative services.
- Intercompany loans, advances, or other extensions of credit (such as trade receivables).
- Loan guarantees.
- Transfers or licenses of intangible property or rights to use intangible property (including patents, inventions, processes, designs, copyrights, trade secrets and know-how, trademarks, and trade names).
- Sharing costs of developing intangible property.

IRS Focus: Prevent Artificial Income Shifting

The IRS's focus in transfer pricing is to prevent the artificial shifting of taxable income among related entities, especially shifting taxable income outside the US. The transfer of income outside the US through the transfer of rights to develop and exploit intangibles is a particular focus of IRS audits.

US Transfer Pricing Rules

IRC Section 482 gives the IRS the discretionary authority to reallocate income, deductions, credits, and allowances among commonly owned or controlled "trades, organizations or businesses" to prevent evasion of taxes or to clearly reflect income. Only the IRS can use IRC Section 482 to reallocate income and other items among related entities. Taxpayers generally cannot initiate transfer pricing adjustments (Treas. Reg. § 1.482-1(a)(3)).

Generally, a court will uphold the IRS's determinations under IRC Section 482 unless the taxpayer proves that the IRS's allocations are arbitrary, capricious, or unreasonable (*Paccar, Inc. and Subsidiaries v. Commissioner*, 85 T.C. 754 (1985) and *Sundstrand Corp. and Subsidiaries v. Commissioner*, 96 T.C. 226 (1991)).

There is no definition of "control" under IRC Section 482. Relevant Treasury regulations state that "common control" under IRC Section 482 includes any kind of control, whether direct or indirect (Treas. Reg. § 1.482-1(i)(4)). The focus is on actual, practical control rather than a particular percentage of stock ownership (see *DHL Corp. and Subsidiaries v. Commissioner*, 76 T.C.M. 1122 (1998) and *Grenada Industries, Inc. v. Commissioner*, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953)). Control is presumed to exist if two or more entities have arbitrarily shifted income or deductions (Treas. Reg. § 1.482-1(i)(4)).

The rules of IRC Section 482 apply to more than just transactions between subsidiaries owned directly or indirectly by a common parent company. They can also apply to transactions between:

- A partner and partnership.
- Two partnerships owned by the same partners.

- Common parent of a group and a subsidiary.
- A partnership and corporation owned or controlled by the same persons.
- An entity and each of its 50% shareholders if the shareholders have the same business interests in the jointly-owned entity (see *B. Forman Company, Inc. v. Commissioner*, 453 F.2d 1144 (2nd Cir. 1972)).

IRC Section 482 only provides a general outline of the IRS's authority to reallocate income, deductions, credits, and allowances among related entities. Most of the detailed transfer pricing rules are found in Treasury regulations.

A special rule under IRC Section 482 governs transfers or licenses of intangible property. Under this rule, the income for the transfer or license of intangible property (for example, a patent) must be "commensurate" with the income attributable to the intangible (that is, the income earned by using the intangible property to develop products). This special rule allows the IRS to look to the actual income produced by an intangible asset subsequent to the transfer and may cause adjustments even if the IRS has agreed to the taxpayer's pricing for prior years. In addition, IRC Section 367(d) imposes a deemed royalty on the transfer of intangible property to a foreign corporation in certain transactions that would otherwise be tax-free (such as a capital contribution to a foreign subsidiary). The IRS can also require the valuation of transferred intangible property on an aggregate basis, or based on realistic alternatives.

Arm's Length Pricing

The standard the IRS applies in determining the appropriate income of a controlled entity is to compare the prices charged between the controlled entity and related entities for the transfer of goods, services, or intangible property with the prices that would be charged between unrelated entities for substantially the same goods, property, or services under substantially similar terms and conditions (Treas. Reg. § 1.482-1(b)). This arm's length standard looks to market prices, where available, for determining the reasonableness of intercompany prices charged for the transfer of goods and intangible property and provision of services between related entities.

Under this standard, the IRS requires related entities to evaluate their intercompany transactions as if they were separate unrelated entities dealing at arm's length. The Organization of Economic Cooperation and Development (OECD) has also adopted the arm's length standard as the appropriate standard for OECD member states to determine transfer pricing issues.

It is often difficult to identify transactions between unrelated entities that are identical to transactions between related entities. Therefore, under the arm's length standard the focus is on comparing the transaction between related entities with comparable transactions under comparable circumstances (Treas. Reg. § 1.482-1(b)(1)). Whether a transaction between unrelated entities is similar enough to a transaction between related entities for purposes of determining an arm's length price is based on the comparability of the following factors:

- Functions performed, such as:
  - research and development;
  - product design and engineering;

    - manufacturing, production, and process engineering;
    - project fabrication, extraction, and assembly;
    - purchasing and materials management;
    - marketing and distribution;
    - transportation and warehousing; and
    - managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

- Contractual terms, such as:
    - form of consideration charged or paid;
    - sales or purchase volume;
    - scope and terms of warranties;
    - rights to updates, revisions, or modifications;
    - duration of license, contract, or other agreements;
    - termination or renegotiation rights;
    - collateral transactions or ongoing business relationships; and
    - extension of credit and payment terms.

- Risks that could affect prices charged or profit earned, including:
    - market risks;
    - success or failure of research and development activities;
    - financial risks;
    - credit and collection risks;

  - product liability risks; and
  - general business risks relating to ownership of plant, property, and equipment.

- Economic conditions that could affect prices that would be charged or profit earned, including:
  - similarity of geographic markets and relative size of each market;
  - level of market (for example, whether the market is wholesale or retail);
  - market share for products or properties transferred or services provided;
  - location-specific costs of factors of production and distribution;
  - extent of competition in the relevant markets;
  - economic condition of the relevant industry; and
  - alternatives realistically available to the buyer and seller.

- Property or services transferred, including whether there is any intangible property embedded in tangible property or services.

(Treas. Reg. § 1.482-1(d)(3).)

If there are significant differences in these factors between related entity transactions and transactions between unrelated parties, adjustments may need to be made to the prices charged in the unrelated party transactions to reflect an arm's length price. For example, volume differences may affect the price charged. Assume that Foreign Subsidiary sells a product to US Parent and also sells the product at $1,000 per unit to unrelated buyers. The volumes purchased by US Parent exceed the volumes purchased by unrelated buyers. If Foreign Subsidiary offers unrelated buyers a discount of 5% for orders of 100 per order and US Parent orders quantities of 105 units per order, it may be reasonable for Foreign Subsidiary to charge US Parent $1,000 per unit less a 5% discount (for a price per unit of $950).

Acceptable Methods for Determining Arm's Length Prices

Treasury regulations under IRC Section 482 provide the acceptable methods to determine the price that should be charged for transactions between related entities. All of the methods attempt to determine what unrelated entities would charge in similar transactions. The six basic methods are:

- **Comparable uncontrolled price.** This method compares the price charged for the sale or transfer of a product, service, or intangible between related entities with the price charged in comparable transactions between unrelated entities. This method may be appropriate if a:
  - Manufacturer sells the same product to both related and unrelated entities.
  - Company licenses the use of an intangible, such as a patent, to both related and unrelated entities.
- **Resale price.** This method is most commonly used for sales of goods or products by a related seller to a related buyer, when the related buyer adds little or no value to the product and on-sells the goods or products to unrelated buyers. This method backs into the arm's length price for sales between related entities by:
  - determining the price (the resale price) at which the related buyer resells the property to an unrelated buyer; and
  - subtracting an appropriate markup to be earned by the related buyer, usually stated as a percentage of the resale price (similar to a commission). The resale price less the appropriate markup is the price that should be charged by the related seller to the related buyer.
- **Cost plus.** This method determines the arm's length price for sales of property or the provision of services between related entities by:
  - determining the costs of producing the property or service; and
  - adding an appropriate markup to the costs (usually a fixed percentage of the relevant costs).
- **Comparable profits.** This method determines the arm's length price for sales of goods or products or the transfer of intangible property between related entities by comparing the profits earned by one of the related entities (the tested party) with profits earned by companies with similar business lines selling similar goods or products or transferring similar intangible property to unrelated entities. The tested party could be either the related seller or related buyer, depending on which party's operating profit can be most easily compared with operating profits of unrelated companies in similar businesses. Operating profit may be measured by:
  - Rate of return on capital (ratio of operating profit to operating assets).
  - Financial ratios (such as the ratio of profits to costs or the ratio of profits to sales revenue).
- **Profit split.** This method estimates the arm's length price for the sale of goods or the transfer of intangible property relating to a specified business activity by dividing the combined profits of the related entities from the relevant business activity based on each entity's relative economic contributions to the activity.

- **Unspecified methods.** Taxpayers and the IRS may not always be able to apply the specified methods to determine relevant arm's length prices. In these cases, a different method may be used if it provides information on the prices or profits that a taxpayer could realize if it chose a realistic alternative to the transaction with a related entity. Unspecified methods are used often, primarily in the financial services industry and in heavily service-based industries where the profit split method cannot be applied.

The basic methods were developed for transfers of tangible property between related entities. Special methods apply to the provision of services (Treas. Reg. § 1.482-9) and to intangible property subject to a cost sharing agreement (Treas. Reg. § 1.482-7). For a discussion of the methods that apply to the provision of services, see Practice Note, US Transfer Pricing: Specific Transactions: Provision of Services Among Related Companies. For a discussion of cost sharing agreements, see Practice Note, US Transfer Pricing: Specific Transactions: Special Rules for Cost Sharing Agreements (CSAs).

Taxpayer Must Choose Best Method

Taxpayers are not free to use any acceptable method to determine the arm's length price that should apply to a transaction between related entities. Instead, the arm's length result must be determined under the pricing method that provides the most reliable measure of an arm's length result (Treas. Reg. § 1.482-1(c)). This is known as the best method rule. This rule requires that the taxpayer both:

- Justify the appropriateness of the chosen method.
- Explicitly show why it did not consider other methods or, if it did consider other methods, why it determined that the other methods are not better than the best method.

In addition, not all methods apply to all transactions between related entities. For example, the resale price method is generally only applicable to sales of tangible property between related entities and does not apply to the provision of services or transfer of intangible property.

A multinational corporation with intercompany transactions subject to the US transfer pricing rules generally prepares transfer pricing studies to document how it determined prices charged for the intercompany transactions in order to avoid penalties (see Contemporaneous Documentation Requirements). These studies must explain why the transfer pricing method chosen by the company is the best method.

In deciding which method provides the best method for determining an arm's length charge, the two main factors taken into account are:

- Degree of comparability between the related entity transaction and transactions between unrelated parties.
- Quality of the data and assumptions used in the analysis.

(Treas. Reg. § 1.482-1(c)(2).)

A company can apply a particular pricing method only if the comparability of transactions between unrelated entities, quality of data, and reliability of assumptions under that method make it more reliable than any other available method for determining an arm's length price (Treas. Reg. § 1.482-8(a)).

For example, assume Foreign Parent manufactures toaster ovens. US Subsidiary purchases toaster ovens from Foreign Parent for sale in the US. Foreign Parent also sells its toaster ovens to an unrelated company for resale in the US. The toaster ovens sold to US Subsidiary are of higher quality than the toaster ovens sold to the unrelated company. In addition, US Subsidiary purchases toaster ovens from unrelated manufacturers for sale in the same US market.

Because the toaster ovens purchased by US Subsidiary and the unrelated company from Foreign Parent are of different quality, the use of the resale price method based on US Subsidiary's purchases of toaster ovens from unrelated manufacturers may provide a more reliable measure of the arm's length price for sales between Foreign Parent and US Subsidiary than using the sales price charged by Foreign Parent on sales to the unrelated company (Treas. Reg. § 1.482-8(b), Ex. 2). For a description of the resale price method, see Acceptable Methods for Determining Arm's Length Prices.

Arm's Length Range

Application of a particular pricing method may in some cases produce a single price that is the most reliable measure of an arm's length price. However, often a pricing method produces a range of prices, especially if there exist comparable transactions between multiple unrelated parties. In these cases, the IRS will not adjust the amounts charged between related entities if the prices fall within this range (Treas. Regs. § 1.482-1(e)(1)).

If the information from the related-party transactions and a group of uncontrolled transactions is not sufficiently complete to conclude that all material differences between the related-party and uncontrolled transactions are identified, the interquartile range of results from the group of uncontrolled transactions ordinarily produces an arm's length result (Treas. Reg. § 1.482-1(e)(2)(iii)). The interquartile range is the range from the 25th to the 75th percentile of results from the group of uncontrolled transactions.

Safe Harbors

Treasury regulations under IRC Section 482 provide limited safe harbor transfer pricing methods for the following specific intercompany charges:

- Interest on loans or advances between related entities (Treas. Reg. § 1.482-2(a)(2)(iii)).
- Charges for certain services performed for a related entity (Treas. Reg. § 1.482-9(b)).
- Rents on certain subleases of property between related entities (Treas. Reg. § 1.482-2(c)(2)(iii)).

For more information on these safe harbors, see Practice Note, US Transfer Pricing: Specific Transactions: Safe Harbor Interest Rates for Certain Intercompany Loans or Advances, Charging at Cost for Low Margin Services, and Safe Harbor for Rents on Certain Subleases.

IRS Penalties for Transfer Pricing Violations are Severe

The penalties for transfer pricing violations can be severe. Under IRC Section 6662, the IRS can impose a penalty of 20% of an underpayment attributable to any substantial valuation misstatement. A substantial valuation misstatement occurs if either:

- The transfer price charged between related entities is 200% or more (or 50% or less) of the arm's length price (transactional penalty).
- The net increase in taxable income for the taxable year resulting from IRC Section 482 adjustments exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts (net adjustment penalty).

(IRC § 6662(e)(1)(B).)

The penalty is 40% if either:

- The transfer price charged between related entities is 400% or more (or 25% or less) of the arm's length price.
- The net increase in taxable income for the taxable year resulting from IRC Section 482 adjustments exceeds the lesser of $20 million or 20% of the taxpayer's gross receipts.

(IRC § 6662(h)(2)(A).)

Whether the penalty applies is based on the transaction prices reflected in amounts the taxpayer reports on its return, whether or not these reported transaction prices differ from the transaction prices initially recorded in the taxpayer's books and records (Treas. Reg. § 1.482-6(a)(2)). If the taxpayer amends its return, the IRS considers amounts reported on the amended return in assessing whether any penalty is due only if the taxpayer files the amended return before the IRS contacts the taxpayer regarding its original tax return. The penalty does not apply unless the underpayment of tax attributable to a Section 482 substantial valuation misstatement exceeds $10,000 for corporations and $5,000 in all other cases.

The purpose of the penalties is to encourage taxpayers to maintain documentation showing how they chose transfer pricing methods for particular transactions and to provide the documentation to the IRS during an audit. Generally a taxpayer is not subject to the transfer pricing penalties if it selects reasonable transfer pricing methods and meets specific documentation requirements (see Avoiding Penalties).

Avoiding Penalties

A taxpayer can generally avoid the transfer pricing penalties if it meets all of the following:

- The taxpayer selects and applies either:
    - a transfer pricing method specified in relevant Treasury regulations in a reasonable manner; or

- an unspecified transfer pricing method, and reasonably concludes that none of the specified methods is likely to produce a reliable measure of an arm's length result and that it selected and applied an unspecified method in a way that will likely provide a reliable measure of an arm's length result (or if no specified methods are specified in relevant Treasury regulations, the taxpayer selected and applied an unspecified method in a reasonable manner).

- Maintains contemporaneous documentation of the transfer pricing methods used (see Contemporaneous Documentation Requirements).

- Provides the required documentation to the IRS within 30 days of a request.

(IRC § 6662(e)(3)(B) and Treas. Reg. § 1.6662-6(b)(3) and (d).)

A taxpayer can also rely on the general reasonable cause exception to avoid the transaction penalty (but not the net adjustment penalty) without meeting the three requirements listed above. Under the reasonable cause exception, a penalty does not apply to any portion of a tax underpayment if the taxpayer can show there was reasonable cause for, and it acted in good faith with respect to, that amount of the underpayment. The determination of whether the reasonable cause exception applies is made on a case-by-case basis and depends on the facts and circumstances relating to the underpayment. The most important factor is the extent of the taxpayer's effort to determine its proper tax liability (Treas. Reg. § 1.6664-4(b)). Reliance on the advice of a tax advisor or accountant (including the opinion of a tax advisor) in assessing the relevant transfer pricing issues does not necessarily qualify the taxpayer for the reasonable cause exception.

Contemporaneous Documentation Requirements

To meet the documentation requirements, a taxpayer must:

- Maintain ten categories of information listed in relevant Treasury regulations.

- Provide the documentation to the IRS within 30 days of a request in connection with an IRS audit.

The IRS requires documentation that provides:

- An overview of the taxpayer's business (including an analysis of economic and legal factors that affect pricing of the taxpayer's property or services).

- A description of the taxpayer's organizational structure covering all related parties engaged in transactions that may be relevant under IRC Section 482.

- Any documentation specifically required by Treasury regulations under IRC Section 482 (for example, documentation required for shared services agreements and cost sharing agreements).

- A description of the transfer pricing method selected and the reason for selecting that method.
- A description of the alternative transfer pricing methods considered and why they were not chosen.
- A description of the intercompany transactions (including the terms of sale) and any internal data used to analyze those transactions.
- A description of the comparables used, how comparability was analyzed and what adjustments were made.
- An explanation of the economic analysis and projections relied on in developing the transfer pricing method applied.
- A description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a return, which would help determine whether the taxpayer selected and applied a transfer pricing method in a reasonable manner.
- A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing these documents.

Except for the last two documentation requirements, the documentation must exist before the return is filed.

A taxpayer must also generally provide to the IRS any background documents that support the principal documentation within 30 days of an IRS request (Treas. Reg. § 1.6662-6(d)(2)(iii)(C)).

Failure to Address Transfer Pricing Issues Can Result in Double Taxation

If the IRS invokes its authority under IRC Section 482 and reallocates income to a US entity from a related non-US entity, the US entity then owes US taxes on the reallocated income. If the non-US entity has already paid non-US taxes on that income, this income is subject to double tax unless either:

- The US entity is allowed a foreign tax credit for the amount of income subject to tax in the foreign country.
- The country in which the non-US entity is located agrees to refund the foreign taxes paid on the reallocated income.

For example, assume US Parent in year one licenses the use of a trademark to Foreign Subsidiary in exchange for annual royalty payments of $1 million. Foreign Subsidiary is subject to a corporate income tax of 20%. In year 1, Foreign Subsidiary earns taxable income of $10 million, based on sales of $15 million minus expenses of $4 million and the royalty payment of $1 million. Foreign Subsidiary pays $2 million in foreign taxes (0.20 times $10 million).

In year two, the IRS audits US Parent and determines under IRC Section 482 that the appropriate arm's length royalty rate is $3 million. This increases US Parent's income for year one by $2 million ($3 million arm's length royalty minus $1 million royalty actually charged). Assuming that this additional $2 million in year one income is subject to a US federal income tax rate of 21%, US Parent is now subject to an additional tax of $420,000 in year one (0.21 times $2 million). However, the $2 million in year one income was already subject to a foreign tax of $400,000 (0.20 times $2 million). If US Parent does not receive a foreign tax credit for the $400,000 in foreign taxes paid or Foreign Subsidiary is unable to receive a refund for these taxes, US Parent is taxed twice on this income.

If a foreign country has an income tax treaty with the US, a US taxpayer may be able to seek competent authority relief under the mutual agreement article of the treaty to avoid double taxation for taxable years that remain open for tax adjustments (meaning generally that the statute of limitations has not expired for the relevant tax years). Under the competent authority procedure, the US and foreign country are asked to agree to the proper amount of income to be taxed by each country so that the taxpayer avoids double taxation. For more information on the competent authority procedure, see Practice Note, US Transfer Pricing: Managing Risks: Competent Authority Protection.

