

## Introduction to Transfer Pricing: Part 1

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### What is “Transfer Pricing?”

The operating units of multinational corporations usually engage in a variety of inter-company transactions. A key issue of international taxation is the problem of “transfer pricing.” The term refers to the pricing of goods and services transferred between related persons not dealing at arm’s length. Prices charged after bargaining between unrelated persons are called “arm’s length” prices.

When unrelated parties deal at arm’s length, the prices at which they transact reflect both prevailing competitive conditions and the specific course of bargaining between them. Among related persons transfer prices answer to no economic pressure. They may reflect a largely unconstrained decision by the parties to adjust accounts among themselves. Transfer prices affect the distribution but not the absolute amount of gain or loss among related persons. If entities within a related group face different tax environments, or different rates of taxation, transfer pricing may bear decisively on tax consequences. Departure from arm’s length prices between affiliates organized in different countries may shift taxable income to low-tax environment and deductible expense to a high-tax one.

From the earliest days, the U.S. tax laws have had provisions designed to strengthen the Treasury’s hand in dealing with artificially priced transactions between related parties. The provisions are embodied in the present Code Section 482. This code section empowers the IRS to reallocate income and expense in transactions between related persons so as to reflect income clearly. Section 482 is aimed at the unilateral advantage related taxpayers could otherwise obtain through unchecked transfer prices. Its goal, broadly stated, is to recast transactions among affiliates.

### Transfer Pricing Penalty Provisions

The provisions of Code Section 482 are given substance by the penalty provisions of Code Section 6662(e). The penalty provisions contain a substantial valuation misstatement penalty that applies specifically to inter-company transactions. Two components comprise this transfer pricing penalty. It can result if either (1) transfer prices are set that are substantially different from the Code Section 482 price, or (2) the IRS re-determines taxable income on the basis of non-arm’s length pricing and such income re-determination exceeds a certain dollar threshold. Thus, either an adjustment attributable to a specific pricing arrangement or the cumulative effect of a series of adjustments in a taxable year can result in the imposition of a penalty.

Specifically, a substantial valuation misstatement will result if:

1. The price for any property or services, or for the use of property, claimed on the taxpayer’s income tax return in connection with a controlled transaction is 200 percent or more (or 50 percent or less) of the arm’s length price (commonly referred to as the “transactional penalty”), or
2. The “net Code Section 482 transfer price adjustment” for the taxable year exceeds \$5 million or 10 percent of the taxpayer’s gross receipts (commonly referred to as the “net adjustment penalty”). The term “net Code Section 482 transfer price adjustment” means, with respect to any taxable year, the cumulative net increase in taxable income from the adjustments under Code Section 482 in the price for any property or services (or for the use of property). For this purpose, taxable income is determined without regard to any carry-backs or carry-forwards to such taxable year from another taxable year.

The penalty is equal to 20 percent of the portion of the underpayment of tax that is attributable to the substantial valuation misstatement. The 20 percent penalty is increased to 40 percent for “gross valuation misstatements,” which occur if the percentages are 400 percent or more (or 25 percent or less) under the transaction test. The increase also applies if the net Code Section 482 transfer price adjustment for the taxable year exceeds the lesser of \$20 million or 20 percent of the

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taxpayer's gross receipts. A diminimus rule provides that no penalty will result unless the underpayment attributable to the substantial valuation misstatement exceeds, for the corporate taxpayer, \$10,000.

To avoid the penalty provisions, a taxpayer must prepare and document a well-reasoned analysis demonstrating why it chose a particular transfer pricing methodology, why it applied the methodology, and the manner in which it used third-party data to support the arm's length result. Documenting each of these steps is essential not only to support the method, but also to avoid penalties. Although the IRS and the taxpayer may disagree on the appropriate transfer pricing method or the proper application of data so that a taxpayer is subject to a Code Sec. 482 adjustment, if the taxpayer has adequately documented its methodology, it may nevertheless avoid penalties –and penalty avoidance may be the primary goal anyway. While reasonable and adequate documentation may not eliminate IRS/taxpayer differences, it dramatically reduces the likelihood of penalties, which can be substantial.

### **Transfer Pricing in Other Countries**

Many other countries have adopted transfer pricing rules. Many have also adopted guidelines issued by the Organization for Economic Corporation and Development. A methodology and transfer price the IRS may accept, however, may not be acceptable to a foreign country's taxing authority.

Although contemporaneous documentation provides protection in most developed countries from a transfer pricing penalty, the documentation in these foreign countries is not as rigorous as the U.S. requirement. For example, only Australia, Japan and the Netherlands require that documentation explain why the taxpayer rejected the alternative methods.

The task of meeting the requirements for multiple countries can be daunting. As a result, the U.S., in conjunction with the tax administrators of Australia, Canada and Japan announced documentation requirements that will provide penalty protection in multiple countries. Nevertheless, the documentation package does not provide certainty with respect to the different methods preferred in various countries.

### **What's next?**

In the current environment, transfer pricing strategy is driven, to a great extent, by the need to develop an effective defense against the transactional and net adjustment penalties. The first step in developing a defense against these penalties is to assess the amount of risk associated with the company's current position. In our next newsletter, we will further discuss this issue as well as how to develop a transfer pricing strategy, in order to make more informed decisions and to streamline your operations.



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