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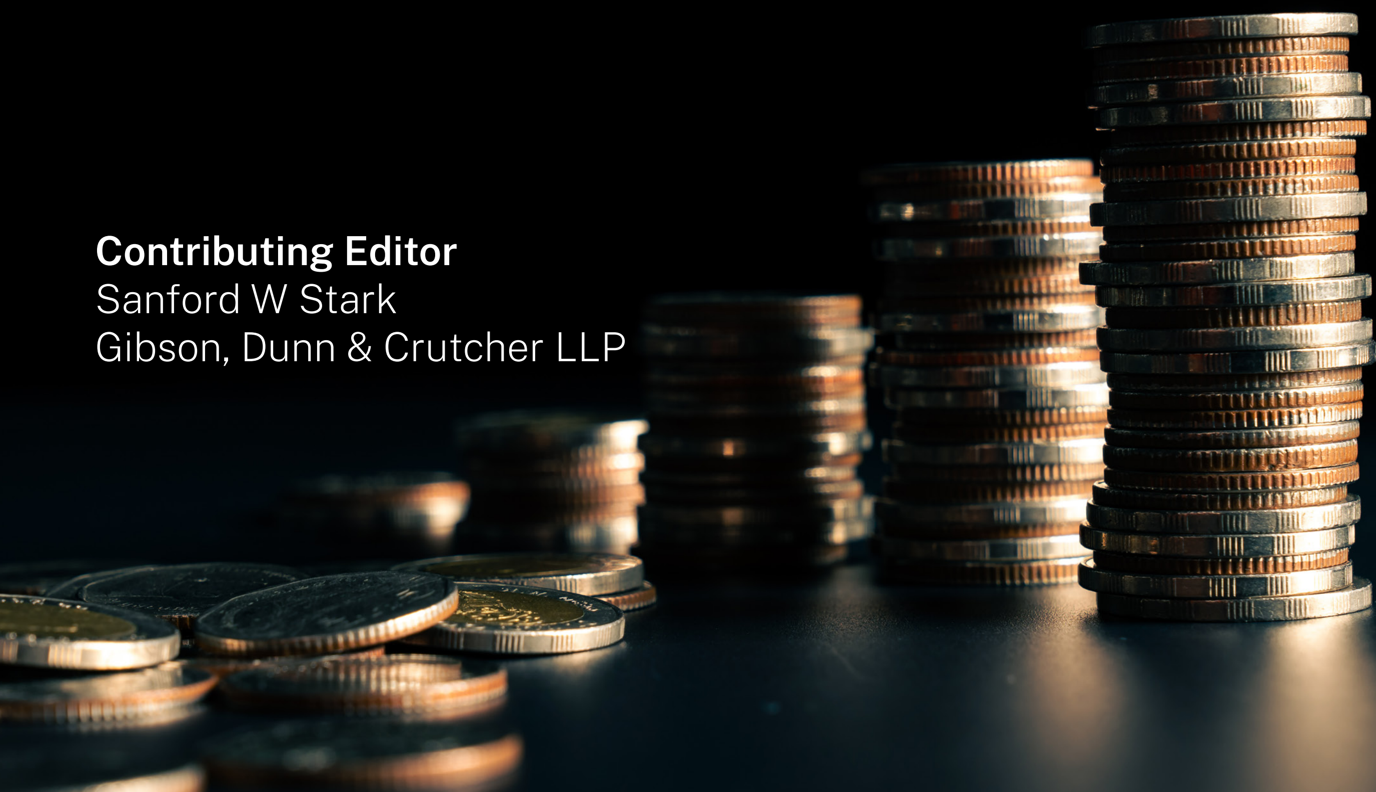

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Global Practice Guides

Transfer Pricing

Contributing Editor

Sanford W Stark

Gibson Dunn & Crutcher LLP

2024

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Gibson, Dunn & Crutcher LLP is a full-service international law firm that advises on some of the most significant transactions and complex litigation around the world. Consistently achieving top rankings in industry surveys and major publications, Gibson Dunn & Crutcher is distinctively positioned in today's global marketplace, with more than 1,800 lawyers and 20 offices, including Abu Dhabi, Beijing, Brussels, Century City, Dallas, Denver, Dubai, Frankfurt, Hong Kong, Houston, London, Los Angeles, Munich, New York, Orange County, Palo Alto, Paris, San Francisco, Singapore and Washington, DC. Gibson, Dunn & Crutcher's global tax controversy and litigation group represents multinational corporations, privately held companies, investment funds, partnerships, sovereign wealth funds and individuals in resolving a broad range of complex domestic and cross-border tax disputes. It works with clients at all stages of tax controversy, ranging from audit and administrative resolution through to trial court proceedings and judicial appeals. The tax controversy and litigation lawyers work closely with the firm's market-leading corporate, commercial litigation, intellectual property, appellate and other practices in a variety of contexts.

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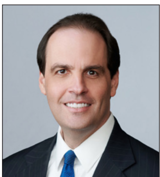

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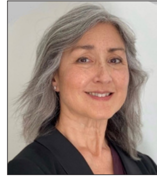

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INTRODUCTION

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Transfer Pricing 2024 – Global Overview

Transfer pricing remains a primary focus of the international tax community. International efforts led primarily by the OECD, together with increasing unilateral efforts by individual governments worldwide, have created an ever-more complex and contentious environment for multinational enterprises (MNEs) seeking to meet their global obligations. The financial strains placed on governments by the recent COVID-19 pandemic have only exacerbated these pressures.

OECD Leads a Global Transfer Pricing Agenda Now Focused on a Two-Pillar Framework

The OECD continues to lead international efforts to harmonise transfer pricing principles and obligations. In 2022, the OECD published a new version of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines") reflecting principles raised in the final reports on the OECD's initiative to combat base erosion and profit shifting (BEPS). With the participation of the G20 and Inclusive Framework members, many countries have embraced the OECD's guidance in whole or substantial part. Most recently, and ongoing, the OECD has focused on addressing tax issues related to the growing digitalisation of the global economy. Members of the OECD/G20 Inclusive Framework have now unanimously adopted a two-pillar approach. The group continues to issue guidance to countries that have enacted or are considering enacting legislation consistent with the two-pillar approach – Pillar One and Pillar Two.

The Pillar One proposal includes two parts – Amount A and Amount B. Under Amount A, MNEs with income above a certain threshold would be required to pay a "tax on residual profits" in countries where they generate significant revenue, without regard to physical presence. The tax would be calculated based on a formula that considers the MNE's sales, employees, and assets in each jurisdiction, as well as a fixed return for routine activities. The proposal also includes mechanisms for resolving disputes between countries and ensuring that the tax does not result in double taxation. Pillar One Amount A is intended to cover both highly digitalised businesses and consumer-facing companies with cross-border activities. Pillar One Amount B provides a simplified and streamlined approach to the application of the arm's length principle to baseline marketing and distribution activities. The OECD's February 2024 report on Amount B was incorporated into the OECD Guidelines as an annex, and jurisdictions can choose to apply the Amount B approach for fiscal years commencing on or after 1 January 2025. Individual countries have the option to apply the Amount B approach and, if applicable, whether it will be optional or mandatory for companies operating in that country.

Pillar One Amount A's move away from physical nexus requirements appears contrary to the emphasis on physical presence in the OECD's earlier BEPS work and the OECD Guidelines. Those pronouncements placed a heavy weight on the physical presence of personnel – including, notably, with respect to development, enhancement, maintenance, protection and exploitation (DEMPE) functions – in determining economic ownership of intangibles and assumptions of risk, and consequent profit and loss allocations, for transfer pricing purposes.

It remains to be seen whether Pillar One Amount A portends a broader movement away from the arm's length standard – which has long been the bedrock of international transfer pricing – or whether it is more reflective of the current politi-

cal environment in which transfer pricing is seen as a tool to advance certain policy objectives. But regardless of which view ultimately prevails, Pillar One Amount A provides a clear example of the challenges facing MNEs as they try to navigate the shifting sands of the international transfer pricing environment. The OCED's current plan is to continue to work on an agreed Multilateral Convention to implement Pillar One Amount A, after an initial draft was released in October 2023.

Pillar Two of the OECD's plan focuses on achieving a minimum global tax rate of 15% for all MNEs above a certain income threshold. Pillar Two has progressed far more than Pillar One, with many jurisdictions already implementing legislation to incorporate Pillar Two effective in 2024. Pillar Two relies on the arm's length standard for pricing controlled transactions, and transfer pricing will remain important under the new regime.

Unilateral Measures by Individual Jurisdictions Create Transfer Pricing Challenges for MNEs

Compounding these global challenges are unilateral measures undertaken by individual jurisdictions to buttress their own transfer pricing regimes. While many countries have agreed to repeal their digital services taxes (DSTs) pending implementation of Pillar One Amount A, some continue to apply them or intend to implement them if Pillar One Amount A is not implemented. This uncertainty only adds to the complexity that MNEs face in the international market.

Beyond the DST realm, individual jurisdictions have taken unilateral measures in other areas as well, relying on domestic measures even as they await and apparently support broader OECD initiatives.

Canada

In Canada, for example, the Canada Revenue Agency (CRA) has looked to the "recharacterisation" rule in the Canadian Income Tax Act to try to recharacterise intercompany transactions that the CRA believes would not have occurred at arm's length. The CRA has advanced arguments under the recharacterisation rule in two recent cases, both times unsuccessfully, but shows no sign of abandoning the argument going forward. The CRA has even declared that, because it views the recharacterisation rule as a domestic anti-abuse measure, it will not negotiate application of the rule in the mutual agreement procedure (MAP) process. Instead, it will only participate in a MAP to enable the counterparty to provide correlative relief. Canada continues to focus on, and is looking to modernise, its general anti-avoidance rule.

The UK

The UK diverted profits tax (DPT) is another example of a domestic measure to strengthen an individual jurisdiction's transfer pricing enforcement tool kit. The DPT targets MNEs that use what HM Revenue & Customs (HMRC) considers to be artificial arrangements to divert profits from the UK corporation tax net. Introduced on 1 April 2015, the DPT currently carries a punitive 31% rate (compared to the current UK corporation tax rate of 25%) on profits falling within its scope. There are two ways in which a taxpayer's multinational structure could be caught by the DPT:

- a company in the structure (UK or non-UK resident) is party to an arrangement that lacks economic substance; or
- avoidance by a non-UK company of a UK taxable presence.

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A DPT charging notice from HMRC brings heightened transfer pricing scrutiny in addition to the risk of liability for a 31% charge on a portion of the taxpayer's profits. And to increase disclosure of potential DPT subjects, HMRC requires taxpayers requesting an advance pricing agreement (APA) to state their opinion as to whether the DPT is likely to apply to their arrangements.

Australia

Australia enacted its own DPT in 2017, aimed at ensuring that "significant global entities" pay tax consistent with the economic substance of their activities in Australia, and preventing the diversion of profits offshore through related-party arrangements. Where arrangements are found to divert profits from Australia to a country with an effective tax rate below 24% and there is insufficient economic substance to justify those profits, a DPT liability is assessed at 40% of the diverted profits. In enacting the DPT, the Australian government stated that approximately 1,470 taxpayers were in the DPT's scope, 130 of which were estimated to be in the "high risk" category. There is ongoing DPT litigation in the Federal Court of Australia.

France

France has taken the concerning step of introducing the risk of criminal exposure in transfer pricing disputes. The OECD's November 2017 document titled "Fighting Tax Crimes: the Ten Global Principles" stated that "it is important that jurisdictions have the possibility of applying criminal sanctions in respect of violations of the tax law". Since 2018, the French tax administration has been obliged to forward to the public prosecutor any tax audit file that gives rise to a reassessment above EUR100,000 and the application of certain specified penalties. The law is broad and could significantly increase the number of criminal referrals and prosecutions, including, potentially, on issues of transfer pricing.

Belgium

In addition to these and other statutory or regulatory enhancements to individual jurisdictions' transfer pricing frameworks, countries are also bringing to bear additional resources in aid of their transfer pricing enforcement efforts. In Belgium, for example, the specialised transfer pricing department ("TP cell") within the Belgian tax authority has, in recent years, expanded and significantly increased its activities, including in conjunction with local audit teams. The Belgian special tax investigation team (the team that typically conducts dawn raids) has also increased its focus on transfer pricing, with some senior members from the TP cell having joined this team. Information gathered through dawn raids is often used by the team to perform and test functional analyses of the relevant Belgian taxpayers. The Belgian tax authority is also increasing its use of data mining and data analytics techniques to risk-assess taxpayers for potential transfer pricing exposures. The use of these techniques is growing in a host of other jurisdictions as well.

Increasing Use of APAs and MAPs to Address a Rise in Controversy/Litigation and the Risk of Double Taxation

The cumulative effect of all the above is, not surprisingly, heightened controversy. Virtually every jurisdiction reports that transfer pricing audits are increasing in number, complexity and amounts assessed, and are increasingly accompanied by assertions of penalties. The increased audit activity is often unilateral, but there is also reported growth in bilateral and multilateral audits. And the issues in scope span the gamut – for countries adhering to OECD guidance, there

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is a heavy focus on DEMPE functions and, where relevant, hard-to-value intangibles.

A number of jurisdictions are focusing on intercompany financing transactions, challenging the interest rates charged on intercompany loans, the pricing of guarantee fees, and the nature and pricing of cash pool arrangements. Marketing intangibles are another source of controversy, as are business restructurings generally. And virtually all jurisdictions are witnessing or predicting growth in transfer pricing litigation, as increasingly aggressive enforcement activities prove unresolvable at administrative levels. In this contentious environment, the risk of double taxation presents major concerns.

Fortunately, APAs and MAPs exist to help mitigate double tax concerns. But those systems are already resource-constrained and demand appears only to be growing. Several jurisdictions are establishing or growing their APA programmes, and many jurisdictions report increasing taxpayer demand for the certainty an APA can afford. The process remains slow, with APAs often taking three years or longer to complete.

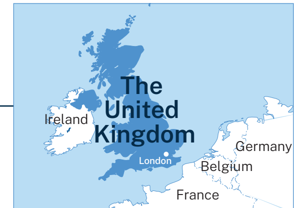
MAP availability is critical to resolving the competing claims, and double tax risks, arising from the landscape described above, and, as with APAs, a number of countries are establishing or growing their MAP resources. But the MAP network is at severe risk of overload even before the full impact of the OECD's BEPS initiatives is absorbed. In November 2023, the OECD released MAP statistics for 2022 which reflected that more than 2,300 MAP cases were closed in 2022. This was a decrease relative to 2021, resulting in a slight increase in ending inventory over the previous year.

The Lingering Impact of COVID-19 Exacerbates Tensions in the Transfer Pricing Landscape

While the COVID-19 crisis appears to be over, this remains an extremely challenging time for taxpayers seeking to manage their global transfer pricing concerns amid a more dynamic and uncertain economic environment. Important aspects of the landscape appear to be changing and evolving in real time, creating heightened uncertainty, increasing controversy and litigation, and risking overload of the APA and MAP processes designed to offset these pressures and avoid double taxation.

This confluence of circumstances already existed before the pandemic, and the financial strains on government coffers brought about by the pandemic and other macroeconomic events only exacerbated the tensions. Yet, there is also hope that the past is a prologue and that interested stakeholders will find a way to work through their differences to find common ground. Until then, it is sure to be an extremely interesting time for all involved.

UK



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Transfer Pricing in the UK as of 7 March 2024

UK statistics

The UK tax yield from transfer pricing (including from related actions and enquiries) rose marginally to GBP1,635 million in 2022–2023 (up from GBP1,482 million in 2021–2022 but still down from the high watermark of GBP2,162 million in 2020–2021). The 2022–2023 revenue stems from a lower number of settled enquiries (153, down from 175 in 2021–2022), indicating increasing HMRC focus on higher value actions.

Interestingly, only 15 Advance Pricing Agreements (APAs) were agreed with HMRC during the 2022–2023 tax year (down from 20 in 2021–2022, and the recent high point of 30 in 2018–2019). With APAs taking an average of over 45 months to agree (albeit down from over 58 months in 2022–2023) it is unsurprising that there has been some reluctance from taxpayers to pursue the process. The delays stem from HMRC's approach in entering into bilateral or multilateral agreements with interested jurisdictions. In particular, a taxpayer's business operations could undergo material changes in the period taken to reach agreement. In contrast, the average time to resolve mutual agreement procedure (MAP) cases is 28.4 months (up from 21.1 months in 2021–2022), which may have further encouraged taxpayers to seek forgiveness rather than consent.

However, recent figures indicate a change in this approach, with the number of APA applications increasing significantly in recent years (to 45 in 2022–2023, up from 40 in 2021–2022). With Pillar II proposals taking effect in many jurisdictions this year, this increase is understandable: Transfer pricing allocations will have a key impact in determining the effective tax rate in relevant jurisdictions, meaning that any subsequent challenge to transfer pricing will have a knock-on impact on Pillar II calculations. This heightens the risk of double taxation, as well as the related administrative burden (in having to resubmit returns, for example), increasing the benefits of achieving certainty via APAs.

In contrast to APAs, the number of Advance Thin Capitalisation Agreements (ATCAs) in force has fallen hugely, from 334 in 2017–2018 to only 30 in 2022–2023. This is primarily due to the introduction, in 2017, of the corporate interest restriction, an additional regime which broadly limits deductions for UK finance expenses to 30% of an adjusted EBITDA. In practice (although transfer pricing rules take priority under applicable law), the relatively formulaic operation of the corporate interest restriction means that it serves as the first line of defence against tax deductions, thereby reducing pressure on transfer pricing analysis in a finance context. Staffing levels within the relevant HMRC team have not fallen

in this period, so, at first glance, it is perhaps surprising that this drop-off in ATCAs has not resulted in an appreciable reduction in the average time to agree APAs. However, this relative increase in HMRC manpower has been offset by APA processes becoming ever more complex as a result of increases in (i) the data available to HMRC (eg, as a result of country-by-country reporting (CbCR) rules), and (ii) the jurisdictional spread of taxpayer operations (as to which, see further below).

Unfortunately, the trend towards increasing complexity in the application of transfer pricing rules looks likely to continue.

Complexity arising from increased mobility

One of the key impacts of the recent pandemic, which is likely to impact transfer pricing for many years to come, has been the increased mobility of the workforce. Indeed, it is becoming increasingly necessary for multinational groups (MNGs) to offer flexibility/hybrid working of this kind to attract, and retain, key talent. This has led to an increased likelihood of (i) MNG functions being spread across an increased number of jurisdictions (including jurisdictions in which relevant MNGs have not had a historic presence and which may not have material experience in, or resources to devote to, negotiating and agreeing APA and MAP processes), and (ii) individuals holding key decision-making or risk functions carrying out such functions across a number of jurisdictions. Countries such as Croatia, Portugal, Brazil and Estonia (which have not historically served as locations where material MNG functions are carried out) have opened up specific visas for individuals working remotely, increasing the likelihood of these countries being drawn into disputes of this kind.

This flexibility in working arrangements is expected to materially complicate the transfer pricing exercise in the coming years, and to increase the information required to be maintained by MNGs to support positions taken.

- Historical means of allocating profits between low-risk functions, such as number of employees or floorspace, would need to be tracked on an ongoing basis, and/or may no longer serve as appropriate measures, respectively.
- For high risk/value functions, the roles and responsibilities of individuals would need to be reviewed with enhanced granularity (to consider whether the work carried out in a particular jurisdiction gives rise to a permanent establishment there and, if so, the appropriate level of profit attribution).
- While transfer pricing rules have always required transactions to be priced based on the reality on the ground, unless adequate limitations are put in place to restrict employees' ability to carry out certain functions in particular jurisdictions, it will be increasingly difficult to predict and apply outcomes ahead of time, at the cost of MNGs' certainty and ability to plan.
- Taxpayers that are party to APAs will need to be mindful that any flexibility proposed to be offered to employees does not breach the terms of any existing APAs.
- Timeframes in which APAs can be agreed and MAPs and other disputes resolved are likely to be extended, as it will be necessary for tax authorities to consider information at a previously unnecessary granular level of detail.

Such complexity seems likely to increase the risk of double taxation. In particular, jurisdictions to which profits were traditionally allocated may be reluctant to accept (and hence more likely

to challenge) reductions in such allocations. In addition, given that OECD Pillar I proposals (if implemented) are expected to reduce the taxing rights of jurisdictions that have typically served as MNG headquarters (such as the UK, the US and the Netherlands), there is a risk that tax authorities in such jurisdictions may increasingly look to transfer pricing to stem expected revenue losses, becoming more aggressive in their approach thereto.

Somewhat helpfully, the Organization for Economic Co-operation and Development (the OECD) has identified tax complexities arising from the increase in remote-working as one of two key tax areas (together with climate change) on which it plans to focus in the near future. Such work will continue on from the helpful guidance published by the OECD in 2020 and 2021 in response to the pandemic (which covered employment tax, and residency and permanent establishment risk, as well as separate transfer pricing guidance). However, in recent years, the vast majority of OECD resources have been devoted to progressing Pillar I and Pillar II workstreams, and it is disappointing that no definitive timeline for, or scope of, the remote-working project has yet been published. It is hoped that:

- this workstream can be accelerated;
- the scope of the project addresses the full range of resulting tax complications, across personal, corporate (including transfer pricing) and indirect tax; and
- the need for timely progress is not at the expense of thoughtful consideration, and appropriate stakeholder input, as to how the burden of increased tax complications and compliance for taxpayers can best be mitigated.

Increase in data-keeping obligations and data available to tax authorities

HMRC has, in recent years, indicated a need to plug a perceived "information gap" in the context of transfer pricing. More detailed record-keeping requirements, and an increase in the data available to tax authorities, have followed, and are likely to be features of transfer pricing going forward. Indeed, if anything, the greater risk is that the information available to HMRC and other tax authorities may outweigh their resources to properly consider it.

Looking at the UK in particular, in 2023, transfer pricing record-keeping requirements were expanded.

- Broadly, UK taxpayers subject to CbCR (ie, those that are members of MNGs with global revenue of at least EUR750 million) are now required to maintain a local file and master file containing the information described in Annexes I and II to Chapter V of the 2022 OECD Transfer Pricing Guidelines (eg, a description of local management functions, a functional analysis of material related-party transactions, a description of the transfer pricing policy applied thereto and information supporting the taxpayer's view that the policy is arm's length). The files can be requested by HMRC at any time, must be provided within 30 days of request and taxpayers that fail to comply will be subject to a rebuttable presumption that errors are careless (such that tax geared penalties would apply). The changes are consistent with the information that HMRC would have expected taxpayers to maintain as part of their obligations to keep records supporting their corporation tax returns, so are not expected to materially increase transfer pricing obligations for in-scope taxpayers. However, interestingly,

HMRC guidance advises large businesses that are not in scope to voluntarily prepare such data, suggesting a level of "mission creep" that may be of concern to relevant taxpayers.

- HMRC was also empowered to introduce legislation requiring in-scope taxpayers to prepare a short "Summary Audit Trail" (SAT). The SAT would set out the steps taken by the taxpayer in preparing the local file, to enable HMRC to undertake "high level quality assurance" on the data provided. Such legislation was delayed, pending a consultation that was due to take place in 2023 (but has not yet opened). Taxpayers have voiced concerns that:
  (a) the SAT may replicate information contained in the files themselves (thereby increasing compliance without any benefit to HMRC);
  (b) the requirement goes beyond international consensus; and
  (c) the requirement would, if genuinely necessary, be best implemented as part of a multilateral process to ensure standardisation.

In light of this, it is hoped that HMRC may decide not to pursue the proposal further.

In addition to an increase in legislative requirements, tax authorities, including HMRC, are likely to have access to an increase in publicly available information regarding taxpayers, due to a trend toward increasing tax transparency.

- EU public country-by-country requirements will take effect this year. Where MNGs subject to the rules have UK operations, the information published thereunder would in any event be available to HMRC under CbCR exchange of information rules. These EU disclosures will nevertheless constitute an additional source of information to HMRC, as they will provide comparative detail on non-UK operations. This additional information is likely to lead to enhanced scrutiny of benchmarking by UK taxpayers, and a better understanding by HMRC of how the UK fits into wider MNG operations. (The same is true of EU proposals to require large taxpayers to publicly publish their effective tax rate, if implemented.)
- MNGs are becoming increasingly focused on economic, social and governance (ESG) standards. Two of the most widely-used ESG standards, produced by the Global Reporting Initiative and the World Economic Forum, respectively, both include standards on tax transparency (proposing, for example, that signatories publish figures for their total tax paid, with varying degrees of specificity). While there has not yet been wide-spread take-up of voluntary tax disclosure standards, it is likely that there will be some movement in that direction in the coming years, and that MNG may come under increasing pressure to publicise information regarding their tax affairs.

This increase in publicly available information means that MNGs' transfer pricing may be subject to scrutiny not only from tax authorities, but also from the wider public and the press (who may not have appropriate experience or context to interpret it). As such, transfer pricing is likely to represent an increasing reputational risk, and may be subject to increased attention from non-tax executives within MNGs. This creates enhanced risks of challenge, as it seems likely that, where MNGs' tax positions are subject to public or press scrutiny, tax authorities will feel emboldened in pursuing enquiries and assessments.

Proposals for limited simplification

The increased complexity of MNG operations (as a result of globalisation, changes in supply chains, and the above-mentioned mobilisation) in recent years has increased the burden of transfer pricing compliance. Taxpayers have, as a result, called for simplification.

Such calls have been acknowledged in the UK by HMRC, and at an international level by the OECD, with varying degrees of success. Proposed changes contemplated by HMRC seem to be a welcome step toward a more pragmatic approach. However, the resulting benefits are likely to be outweighed by failures to reach international consensus on OECD-led proposals.

UK-specific proposals

In summer 2023, HMRC launched a consultation on potential changes to transfer pricing rules, with a general objective of simplifying the application of the rules (where possible). Having considered responses thereto, the government proposes to make some targeted changes which should be helpful to taxpayers, including the following.

1. UK–UK transactions

UK transfer pricing rules generally apply to UK–UK transactions. This has long been considered by taxpayers to introduce a disproportionate compliance burden (given the low risk of tax-loss to HMRC where UK taxpayers are on both sides of the related- party transaction). Most respondents to the consultation felt that the application of the rules in this context should be limited to scenarios where there is a UK tax advantage (eg, where one party is subject to a higher UK corporation tax rate under specific regimes, such as those applying to oil and gas companies). In response, the government has confirmed it will relax the obligation to apply transfer pricing between UK entities where the UK tax base is not disadvantaged. Respondents were split as to whether this would be best implemented via an express requirement for a UK tax advantage, or more prescriptive drafting (for example, expressly referencing a rate differential) for greater clarity. The government has not yet chosen a preferred approach, although has noted that it will consider whether an exhaustive and specific list of exceptions can be achieved without prejudicing its aim of simplification.

2. Participation condition

The consultation discussed the merits of changing the existing participation condition, which applies, broadly, where entities are under common control (by reference to shareholding, voting power or other powers conferred by governing documents). This was due to government concern that the existing definition of control does not adequately capture circumstances where excessive influence (eg, by major creditors) could impact provisions. Views were sought on a potential move to a more principle-based approach such as:

- the US approach in applying transfer pricing rules where taxpayers are “acting in concert”;
- the Norwegian approach, which requires a “community of interest” (a fact-dependent test that considers whether either party is dependent on, or under the influence of, the other); or
- the Swiss approach, which simply asks whether the tested transaction occurred only because of the relationship between the parties.

Most respondents considered that these alternatives would introduce subjectivity and decrease

certainty, and favoured a prescriptive approach. While little detail has been provided, the government seems to have taken this feedback on board, noting that (i) it will address known problem-cases in a targeted and prescriptive manner (seeking to avoid material increases in the compliance burden), and (ii) where current rules produce uncertainty, amendments will be made.

3. Guarantees

Broadly, current UK law provides that in determining whether a financial transaction between related parties is arm's length, account should be taken of all factors other than the effect of parent guarantees. There is currently doubt as to whether the exclusion extends to implicit support (by virtue of simply being part of an MNG). Following consultation, to better align with the most recent OECD guidance published in 2022, the government intends to amend the legislation to allow regard to be had to (i) implicit support (in line with guidance that the government intends to publish), and (ii) guarantees (within the scope of UK transfer pricing rules that reduce borrowing costs) when determining whether the terms of the debt (but not the amount) are arm's length.

4. Interactions with market value rules

Currently, under UK rules for the taxation of (i) intangibles, there is a market value override which sits alongside the arm's length rule (with taxpayers taxed in accordance with the former if it is higher), and (ii) loan relationships and derivative contracts, related-party transactions are required to be taxed in line with an "independent terms assumption" (which broadly refers to the terms that would have been entered into between knowledgeable and willing parties dealing at arm's length). These various valuation premises were identified as increasing taxpayer compliance, and as potentially creating a different outcome to the outcome under applicable treaties. Following consultation, the government proposes to simplify related-party transactions by (i) only requiring the arm's length provision to be considered for intangibles (thereby allowing related-party intangible transactions to benefit from APAs), and (ii) in the case of loan relationship and derivative transactions, "simplifying and clarifying" the rules (with further detailed information regarding the proposed changes not yet available).

5. Definition of permanent establishment

While not expressly a part of the transfer pricing rules, the consultation also addressed whether to expand the definition of "permanent establishment" to align with the current OECD guidance. Specifically, respondents were asked for feedback on government proposals to:

- expand the definition to cover "dependent agents that habitually play the principal role leading to the conclusion of contracts that are routinely concluded without modification by the enterprise"; and
- narrow the independent agent exclusion to remove any person "act[ing] exclusively or almost exclusively on behalf of one or more enterprises to which [they are]... closely related" (changes, in each case, that were first introduced into OECD commentary in 2017 and against which the UK has reserved its position).

Respondents raised concerns that the proposed changes would lower the threshold for permanent establishments and increase uncertainty in tax treatment and the risk of double taxation. The proposals were considered to be particularly

detrimental for the asset management industry in:

- potentially reducing the scope of activities (eg, discretionary asset management) that could be carried out in the UK without the possibility of a taxable presence; and
- limiting recourse to the independent agent exemption (given that most managers hold interests in funds they manage, and hence are likely to be "closely related").

Respondents noted that, if implemented, there would, in particular, be an immediate detrimental effect on offshore fund structures which rely solely on domestic provisions to prevent the creation of a taxable presence for investors (especially where the structure did not qualify for the UK's "investment management exemption" to prevent such taxable presence, and relied solely on the above definitions). More generally, respondents highlighted that the UK fund industry had been structured around the existing definitions, and that if the proposed changes were implemented, the resulting uncertainty in tax treatment would likely result in fund managers relocating to Luxembourg or Ireland and/or reduced investment into the UK. In light of these concerns, the government noted that it would consider further whether to implement the proposals, but gave assurances that it would, in any event:

- not amend the UK's double tax treaties to mirror any such changes; and
- seek to prevent unintended consequences for offshore investors in UK-managed funds.

OECD

The OECD has attempted to address taxpayers' desire for simplification with a proposal for a streamlined, formulaic approach to transfer pricing for baseline marketing and distribution functions.

Broadly, the formula (so called "Amount B") would be applied on the basis of a "pricing matrix" which uses a specific return on sales as the net profit indicator. The matrix would provide for different pricing depending on (i) the applicable industry, and (ii) whether the taxpayer's expenses and net operating assets, relative, in each case, to revenue, are high, medium or low. Where taxpayers' priced in-scope related-party transactions are in line with the Amount B produced by the matrix, the provision would be deemed to be arm's length.

While it is helpful that the OECD has sought to address taxpayers' requests for simplicity, there are concerns that this dual-track approach may inadvertently increase the compliance burden, with taxpayers having to familiarise themselves with, apply, and police implementation of, a new second standard (in addition to the existing standards applied to other related-party transactions). In particular, such activities typically attract relatively simple and well-understood transfer pricing methodologies, and so the need for alternative standards is not necessarily clear.

Indeed, OECD proposals are likely to increase, rather than reduce, complexity (and the risk of double taxation) in light of recent announcements that:

- the implementation of Amount B rules will be optional for jurisdictions;
- where one relevant jurisdiction has decided not to implement the rules, it would not be bound by the application of the rules in other relevant jurisdictions (eg, for MAP purposes) and Amount B should not be used as the basis for MAP disputes; and

- jurisdictions opting into the proposals can decide whether to allow (on a permissive basis) or require (on a mandatory basis) taxpayers to apply the streamlined "Amount B" approach.

To prevent taxpayers bearing the burden and cost of fragmented approaches to adoption, it is hoped that either (i) international consensus can be reached, so that the rules will be adopted uniformly, or (ii) proposals are abandoned until such time as full consensus can be reached.

Conclusion

Unfortunately, transfer pricing trends generally appear to be moving against taxpayers' interests.

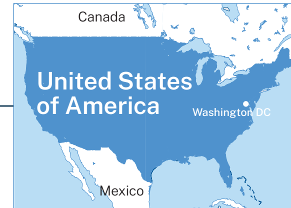
Broadly:

- changes in working practices, and proposed OECD-led tax changes (ironically designed to increase simplicity), seem likely to increase complexity, the risk of double taxation and the timeframe for resolving disputes; and
- increases in data-keeping obligations, and in the information available to tax authorities, are likely to increase taxpayers' compliance burdens and the likelihood of challenge.

While some recent UK developments buck the trend (such as proposed changes to simplify UK transfer pricing rules and recognition of the need for further deliberation before pursuing any changes to the domestic "permanent establishment" definition), they are unlikely to materially move the needle against an otherwise unfavourable outlook. Against this background, it would be prudent for MNGs to:

- build out their internal transfer pricing compliance resources/staffing;
- develop efficient and standardised methods of contemporaneous data collection and analysis (potentially with assistance from artificial intelligence); and
- explore the possibility of APAs to enhance certainty and minimise the risk of challenge.

USA



Law and Practice

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Gibson Dunn & Crutcher LLP is a full-service international law firm that advises on some of the most significant transactions and complex litigation around the world. Consistently achieving top rankings in industry surveys and major publications, Gibson Dunn & Crutcher is distinctively positioned in today's global marketplace, with more than 1,800 lawyers and 20 offices, including Abu Dhabi, Beijing, Brussels, Century City, Dallas, Denver, Dubai, Frankfurt, Hong Kong, Houston, London, Los Angeles, Munich, New York, Orange County, Palo Alto, Paris, San Francisco, Singapore and Washington, DC. Gibson, Dunn & Crutcher's global tax controversy and litigation group represents multinational corporations, privately held companies, investment funds, partnerships, sovereign wealth funds and individuals in resolving a broad range of complex domestic and cross-border tax disputes. It works with clients at all stages of tax controversy, ranging from audit and administrative resolution through to trial court proceedings and judicial appeals. The tax controversy and litigation lawyers work closely with the firm's market-leading corporate, commercial litigation, intellectual property, appellate and other practices in a variety of contexts.

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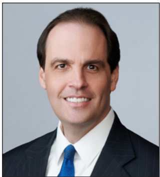

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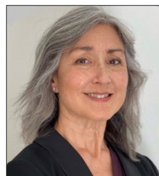

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

In the United States, the rules of transfer pricing are established in terms of statute in Section 482 of the Internal Revenue Code (the "Code") and in terms of regulation in the Treasury regulations beginning with Section 1.482-0 and ending with Section 1.482-9.

The statute itself is brief, merely one paragraph with no subsections. Its role is to establish the government's authority to reallocate income "in order to prevent evasion of taxes or clearly to reflect the income" in controlled transactions.

The US Department of the Treasury (the "Treasury") regulations, on the other hand, are extraordinarily detailed and extensive, establishing the various pricing methods and rules to be applied in multiple circumstances, such as the provision of loans or advances, the transfer of tangible goods or intangible property, or the rendering of services among related parties.

The US Internal Revenue Service (IRS) also regularly issues guidance through revenue rulings, revenue procedures, other agency directives and any number of "informal" guidance that all attempt to address questions of interpretation or enforcement of the transfer pricing provisions.

Finally, there is a long line of federal court decisions interpreting Code Section 482 and applicable regulations and guidance that must be consulted when considering transfer pricing issues.

1.2 Current Regime and Recent Changes

The government's authority to regulate the allocation of income between controlled parties stretches back a long way. The current Code Section 482 has its origins in Section 45 of the Revenue Act of 1928, a provision that was largely unchanged until revisions in 1986, when Code Section 482 was amended to incorporate the "commensurate with income standard" with respect to the transfer (or licensing) of intangible property. More recently, in 2017, Code Section 482 was amended by the Tax Cuts and Jobs Act to capture concepts that had previously been embodied solely in the Treasury regulations, namely with respect to the "aggregation" of transactions among controlled parties in certain circumstances and the consideration of "realistically available alternatives" when pricing intangible property transfers.

The Arm's Length Standard

The "lingua franca" of transfer pricing jurisprudence, the "arm's length standard", is not set forth in Code Section 482, and has never been. However, it has been embodied in US transfer pricing law since the 1930s as part of the Treasury regulations. These regulations have been revised multiple times over the years. The most sweeping revisions followed the "1988 White Paper" commissioned by the US Congress to study and evaluate US transfer pricing following the inclusion of the "commensurate with income standard" in 1986. That led, in 1994, to extensive revisions to the transfer pricing regulations.

Among the most significant changes that arose out of those 1994 changes was to make clear that in performing transfer pricing analyses, there is no "hierarchy of methods" to determine the arm's length price, which had been a major area of dispute for many years. In other words, in considering all of the various methods available to determine the "best method", no method is preferred over any other.

Cost Sharing Agreements

Because some of the most contentious transfer pricing issues in the last 25 years relate to "cost sharing agreements" with respect to the transfer and development of intangible property, there have been many significant revisions to the regulations dealing with such agreements. Indeed, in the 1968 version of the regulations, cost sharing consisted of one paragraph. It has been revised multiple times since 1995, and today, Treasury Regulation Section 1.482-7 (Methods to determine taxable income in connection with a cost sharing arrangement) is one of the most detailed and complex provisions of the transfer pricing regulations.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The US transfer pricing rules apply to so-called controlled transactions. The rules do not require technical control (ie, they do not require that one party to the transaction should own any specified percentage of another party to the transaction). Instead, the test for determining whether a controlled transaction exists (and therefore whether the IRS may apply the transfer pricing rules to reallocate income) is a flexible test that allows the IRS to apply the transfer pricing rules in cases of common ownership (direct or indirect) but also where there is no technical ownership if the parties to the transaction are "acting in concert" with a common goal or purpose.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

US transfer pricing regulations list a number of specific transfer pricing methods that taxpayers can use depending on whether the controlled transactions cover tangible property, intangible property (including cost sharing) or services.

With respect to the transfer of tangible property, the methods are:

- the comparable uncontrolled price ("CUP") method;
- the resale price method;
- the cost-plus method; and
- unspecified methods.

With respect to the transfer of intangible property, the methods are:

- the comparable uncontrolled transaction ("CUT") method; and
- unspecified methods.

Transactions involving both the transfer of tangible or intangible property are also subject to evaluation under:

- the comparable profits method; and
- the profit split method, which includes the:
  - (a) comparable profit split method; and
  - (b) residual profit split method.

With respect to cost sharing arrangements specifically, the methods for valuing any platform contribution of intangibles to such an arrangement are:

- the CUT method;
- the income method;

- the acquisition price method;
- the market capitalisation method;
- the residual profit split method; and
- unspecified methods.

With respect to controlled services transactions, the methods are:

- the services cost method;
- the comparable uncontrolled services price ("CUSP") method;
- the gross services margin method;
- the cost of services-plus method;
- the comparable profits method;
- the profit split method; and
- unspecified methods.

Controlled transactions with respect to loans or advances, cost sharing agreements, and certain services also have detailed regulatory requirements that must be satisfied to determine whether those transactions are in accordance with arm's length principles.

3.2 Unspecified Methods

Under US law, taxpayers can price any controlled transactions using an "unspecified" method if it is the "best method" for determining arm's length results.

3.3 Hierarchy of Methods

Since 1994, there has been no "hierarchy" of methods set forth in the transfer pricing regulations. Although US courts have sometimes shown a preference for transaction-based methods, such as the CUT or CUP methods, in appropriate circumstances, a recent appellate court opinion questioned the Tax Court's application of a transactional method and remanded the case for further consideration – see Medtronic v Commissioner, 900 F.3d 610 (8th Circuit 2018). The Tax Court then applied an unspecified method to try to bridge the gap between the parties. The case is again on appeal.

3.4 Ranges and Statistical Measures

The US has no direct "statistical measure" requirement, although statistics can be used as tools within the various specified methods or in applying unspecified ones.

The "arm's length range" acknowledges that often the arm's length price of a good or service, or profits of an enterprise, will be within an arm's length range of results and will not be a single point. If taxpayers can demonstrate that their results are within that range, then the government will not adjust the prices or profits determined. If, however, the government determines that the taxpayer's price or resulting profits are outside the arm's length range as determined by the taxpayer or the government by the same or a different method, then the government will adjust the taxpayer's results accordingly. When a taxpayer's or the IRS's analysis produces a range of results rather than a single point, the Treasury regulations generally support use of the interquartile range of those results to enhance the reliability of the results and evaluate arm's length pricing, rather than the full range of results, unless all the data points in the range are of sufficiently high reliability as to warrant use of the full range.

3.5 Comparability Adjustments

The US requires comparability adjustments. In determining whether uncontrolled transactions are "comparable" in the first instance for purposes of determining whether the taxpayer's controlled transactions have been conducted in accordance with the arm's length standard, there are a number of factors that need to be considered. And, to the extent that there are differences between the controlled transaction

and the uncontrolled transaction, adjustments for these comparability factors should be considered as well. The factors for determining (and adjusting for) comparability include:

- functions performed;
- contractual terms;
- risks assumed;
- economic and financial conditions;
- the nature of property or services transferred; and
- special circumstances, such as:
  - (a) market share strategy; and
  - (b) different geographical markets (eg, location savings).

4. Intangibles

4.1 Notable Rules

The Commensurate With Income (CWI) Standard

Transfer pricing under US law is governed primarily by Code Section 482 and its implementing Treasury regulations, together with the "Associated Enterprises" Article (usually Article 9) of US tax treaties (if a transfer pricing issue involves an associated enterprise in a treaty jurisdiction). The second sentence of Code Section 482, the statute that gives the IRS the authority to make transfer pricing adjustments, provides: "In the case of any transfer (or license) of intangible property (within the meaning of [Code] section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

This is called the CWI standard. When the CWI standard was added to the Code in 1986, "intangible property" was defined in Code Section 936(h)(3)(B), but in 2017 "intangible property" was redefined more expansively in Code Section 367(d) to include "goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment)". The prior definition in Code Section 936(h)(3)(B) had a residual category, "any similar item, which has substantial value independent of the services of any individual". The newer definition in Code Section 367(d) is modified to read "other item the value or potential value of which is not attributable to tangible property or the services of any individual".

Transfers of Intangibles

Treasury Regulation Section 1.482-4 governs the transfer pricing of intangibles. It points to three specified methods for determining the arm's length consideration for the transfer of an intangible – the CUT method (in Section 1.482-4(c)), the comparable profits method (in Section 1.482-5) and the profit split method (in Section 1.482-6) – and a residual "unspecified method" (in Section 1.482-4(d)), which must satisfy certain criteria.

Section 1.482-4 also provides other special rules for transfers of intangibles. These include rules implementing the CWI standard (Section 1.482-4(f)(2) – "Periodic adjustments"), rules for determining the owner of intangible property (Section 1.482-4(f)(3)), and rules for determining contributions to the value of intangible property owned by another (Section 1.482-4(f)(4)).

Section 1.482-4 provides the specific methods to be used to determine arm's length results in a transfer of intangible property, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by Section 1.482-7. The latter section provides very detailed rules applicable specifically to cost sharing arrangements.

4.2 Hard-to-Value Intangibles

The OECD

Treasury regulations addressing controlled transactions involving intangible property predate and differ slightly from OECD guidance on hard-to-value intangibles (HTVI), which are a subset of intangibles.

Base erosion and profit shifting (BEPS) Actions 8–10 reports treat the HTVI approach as part of the arm's length principle. HTVI are intangibles for which, (i) at the time of their transfer, no sufficiently reliable comparables exist; and (ii) at the time the transaction was entered into (a) the projections of future cash flows/income expected to be derived from the transferred intangibles, or (b) the assumptions used in valuing the intangibles, were highly uncertain. If HTVI requirements are met, in evaluating the ex ante pricing arrangements, a tax administration is entitled to use ex post evidence about financial outcomes to inform the determination of arm's length pricing arrangements.

The HTVI approach will not apply if any one of four exemptions applies.

US Federal Law

By contrast, US federal law takes a slightly different approach, applicable not to a special class of intangibles, but rather to all intangibles. In 1986, Code Section 482 was augmented with the CWI standard. In 1988, Treasury and the IRS agreed to interpret and apply the CWI standard consistently with the arm's length standard (Notice 88-123, 1988-2 C.B. 458, 475). The Tax Court explained that Congress never intended the CWI standard to override the arm's length standard (Xilinx, Inc v Commissioner, 125 TC 37, 56–58, aff'd 598 F.3d 1191 (9th Circuit 2010)).

The periodic adjustment rule

Subparagraph 1.482-4(f)(2)(i) (the "periodic adjustment rule") implements the CWI standard, providing that if an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each year may be adjusted to ensure that it is commensurate with the income attributable to the intangible (ie, actual profits rather than prospective profits). Furthermore, in determining whether to make such adjustments in a taxable year under examination, the IRS may consider all relevant facts and circumstances throughout the period the intangible is used.

Exceptions from application of the periodic adjustment rule

Subparagraph 1.482-4(f)(2)(ii) lists five exceptions from application of the periodic adjustment rule. The four exemptions from application of the HTVI rule mirror these exceptions to some extent, but there are differences. For example, Section 1.482-4(f)(2)(ii)(D) provides relief from potential periodic adjustments if "extraordinary events that were beyond the control of the controlled taxpayer and that could not reasonably have been anticipated" cause actual profits to be substantially different from projected profits. The example provided of an "extraordinary event" is an earthquake. The OECD guidance provides a more favourable exemption – if the taxpayer provides details of the ex ante projections that demonstrate they were reliably prepared and had accounted for reasonably foreseeable events and other risks, then adjustments using ex post profits will not be made.

4.3 Cost Sharing/Cost Contribution Arrangements

The US recognises research and development cost sharing arrangements. Major versions of Treasury regulations addressing cost sharing

arrangements were issued in 1968 (one paragraph), 1995 (15 pages), 2009 (61 pages) and 2011 (77 pages), with amendments and proposed regulations along the way. The 1995 cost sharing regulations were the subject of three significant tax court cases:

- Veritas Software Corporation v Commissioner, 133 TC 297 (2009) (buy-in issue), nonacq. 2010-49 IRB;
- Altera Corporation & Subsidiaries v Commissioner, 145 TC 91 (2015), revised, 926 F.3d 1061 (9th Circuit 2019), en banc rehearing petition denied, 941 F.3d 1200 (9th Circuit 2019) (validity upheld of requirement to share stock-based compensation costs of intangibles); and
- Amazon.com, Incorporated v Commissioner, 148 TC 108 (2017), affiliated, 934 F.3d 976 (9th Circuit 2019) (buy-in issue, and pool of intangible development costs).

Currently, there is one docketed tax court case addressing the 2009 temporary regulations' determination of the "PCT Payment" (the successor of the "buy-in" payment provision under the 1995 regulations).

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Treasury regulations under Code Section 482 do not allow a taxpayer to make an affirmative transfer pricing adjustment after filing a tax return. Section 1.482-1(a)(3) – entitled "Taxpayer's use of section 482" – provides: "If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed US income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions."

Notwithstanding Section 1.482-1(a)(3), there are at least two established paths to post-filing reductions to US income from a transfer-pricing adjustment – one regulatory and one judicial.

The Regulatory Path

The regulatory path addresses set-offs under Treasury Regulation Section 1.482-1(g)(4). Suppose, for example, that in a tax year, B pays A an above-arm's length price in a controlled transaction. If, with respect to another controlled transaction between A and B, in the same tax year, the IRS makes a Code Section 482 adjustment increasing A's income, then A can use as a set-off against (ie, reduction of) the IRS adjustment of the overpayment (ie, excess above arm's length amount) A received from B in the different controlled transaction.

The Judicial Path

The judicial path ties to a line of cases supporting the proposition that if the IRS makes an adjustment with respect to a taxpayer's controlled transaction, then the courts have authority to determine the arm's length transfer pricing for the transaction, even if that results in a refund for the taxpayer (eg, Pikeville Coal Company v US, 37 Fed. Cl. 304 (1997), motion for reconsideration denied, 37 Fed. Cl. 304 (1997); and Ciba-Geigy Corporation v Commissioner, 85 TC 172 (1985)).

Additional Points

In addition to the above regulatory and judicial paths, two other points bear mention. First, under the United States' bilateral income tax treaty network, it is possible for a taxpayer utilising the mutual agreement process to secure a reduction in its reported US income attributable to a transfer pricing position. Second, the CWI standard was originally added in 1986 (and tweaked slightly in 2017), after the progenitor of Section 1.482-1(a)(3) arose, which stated that only the IRS may apply the provisions of Code Section 482. The language of the CWI standard ("shall be commensurate with the income attributable to the intangible") nominally applies both to the IRS and to taxpayers. Accordingly, it may be possible for a taxpayer to assert that the CWI standard gives it the right – for example, in the case of a transfer of intangible property – to override Section 1.482-1(a)(3) and adjust its originally reported taxable income downward (eg, on an amended tax return) to accurately reflect the income attributable to the intangible. This assertion would assuredly be challenged by the IRS; however, this issue has never been addressed by a court.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

The United States is a party to a vast tax treaty network that allows for extensive exchange of information (EOI) among countries. EOI agreements generally authorise the IRS to assist and share tax information with non-US countries to enable those countries to administer their own tax systems and, of course, vice versa. These EOI agreements are memorialised in various forms, including bilateral tax treaties, tax information exchange agreements and multilateral treaties, such as the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters.

Limits, Exceptions and Exemptions

There are few limits on the types of taxes (income, estate, etc) that may be the subject of EOI requests, although each agreement has particular limits on, or exceptions to, the type of information that may be exchanged or how that information may be used among the "competent authorities" of each state. The US tax treaties in general, however, follow the US Model Treaty, which provides in Article 26(1) that: "The competent authorities of the Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes of every kind imposed by a Contracting State to the extent that the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes. The exchange of information is not restricted by paragraph 1 of Article 1 (General Scope) or Article 2 (Taxes Covered)."

Under most EOI agreements with the US, there are few types of information that may not be exchanged. Under many EOI agreements, however, the US is not obliged to exchange information that it deems contrary to public policy or that would disclose trade or business secrets, under the "Business Secrets Exemption". Also, the US, like many European countries specifically, has various "data privacy" laws that may restrict or prevent it from exchanging certain types of information across borders.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

The United States has a robust, well-developed advance pricing agreement (APA) programme. The programme dates back to the early 1990s. It used to be located in the IRS's Office of Chief Counsel but is now located in the IRS's Large Business and International Division (LB&I). In 2012, the APA programme merged with the portion of the US Competent Authority office charged with resolving transfer pricing disputes under the United States' bilateral income tax treaty network to create the Advance Pricing and Mutual Agreement (APMA) programme.

In late 2020, the APMA programme expanded to also include the Treaty Assistance and Interpretation Team (TAIT). TAIT seeks to resolve competent authority issues arising under all other articles of US tax treaties. Since its inception, the United States' APA programme has executed over 2,200 APAs.

7.2 Administration of Programmes

APMA administers the APA programme. According to APMA's most recently published APA annual report in March 2023, covering January through to December 2022, at the end of 2022 "the APMA Program comprised 59 team leaders, 26 economists, nine managers and three assistant directors" in addition to the programme's director. Individual teams include both team leaders and economists. APMA's primary office is in Washington, DC, but it also has offices in California, Illinois and New York.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Both the APA process and mutual agreement procedures (MAPs) fall under APMA's jurisdiction, so the same APMA teams and personnel are responsible for transfer pricing matters regardless of whether those matters arise in an APA context or a MAP proceeding.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Generally, APAs are available to any US person (which includes domestic corporations and partnerships) and any non-US person that is expected to file one or more US tax returns during the years that address the issues to be covered by the proposed APA. As stated in Revenue Procedure 2015-41, which governs APAs in the United States, APAs generally "may resolve transfer pricing issues and issues for which transfer pricing principles may be relevant..." As the Revenue Procedure also states, "APMA may also need to consider additional, interrelated issues, additional taxable years... or additional treaty countries... in order to reach a resolution that is in the interest of principled, effective, and efficient tax administration."

There are limits on APA access for issues that are, or have been, designated to be subject to litigation. Effective 25 April 2023, LB&I issued internal guidance providing a list of criteria APMA personnel should consider in determining whether to accept an APA request or propose alternative APA workstreams, such as the International Compliance Assurance Programme or joint audits with foreign tax authorities. Many commentators view this guidance as reflecting a more selective approach to APA request approvals.

7.5 APA Application Deadlines

APAs can include both prospective (future) years and, where applicable, "roll-back" (prior) years. Roll-back years are addressed in **7.8 Retroactive Effect for APAs**. Designation of the first prospective year of an APA application ties to the timing of the filings of the taxpayer's tax return for the year and the taxpayer's APA request. Generally, the first prospective year is the year in which the taxpayer files a complete or sufficiently complete APA request by the "applicable return date", which is the later of the dates on which the taxpayer actually files its US tax return for the year or the statutory deadline for filing the return without extensions. All proposed APA years ending before the first prospective year will be considered roll-back years. For bilateral or multilateral APAs, APMA requires that the taxpayer files its completed APA request within 60 days of when it filed its request with the foreign competent authority (bilateral) or authorities (multilateral).

7.6 APA User Fees

There are user fees associated with seeking an APA. For APA requests filed after 1 February 2024, the fees are USD121,600 for new APAs, USD65,900 for renewal APAs, USD57,500 for small case APAs (applicable if the controlled group has sales revenue of less than USD500 million in each of its most recent three back years, and meets other criteria) and USD24,600 for amendments. User fees can be mitigated if multiple APA applications are filed by the same controlled taxpayer group within 60 days.

7.7 Duration of APA Cover

There is no prescribed limit on the number of years that can be covered by an APA. An APA application should propose to cover at least five prospective years, and APMA seeks to have at least three prospective years remaining at the time the APA is executed. Roll-back years, if any, will add to the aggregate APA term. According to APMA's most recently published APA annual report, the average term length of APAs executed in 2022 was six years, but the full range of terms spanned from one to 11 years.

7.8 Retroactive Effect for APAs

An APA can cover not only future years, but also prior (or "roll-back") years. Roll-back years are the years of an APA term that precede the first prospective year (see **7.5 APA Application Deadlines**). A taxpayer seeking roll-back coverage should include the roll-back request in its APA application, and APMA can suggest, or even require, the addition of roll-back coverage when the taxpayer does not request it where the facts and circumstances are sufficiently similar across the proposed prospective and roll-back periods.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Specific US Transfer Pricing Penalties

Transfer pricing penalties under the Code and Treasury regulations

Code Section 6662 – entitled "Imposition of Accuracy-Related Penalty on Underpayments" – imposes two specific types of transfer pricing penalties, in addition to other penalties. The penalty regime is somewhat complex and uses a variety of overlapping terms. Code Section 6662(a) provides that if any portion of an underpayment of tax required to be shown on a tax return is attributable to one or more of the causes described in Code Section 6662(b), an amount equal to 20% of the portion of the underpayment attributable to such cause(s) will be added to the tax. The "accuracy-related penalties" arising

from the causes listed in Code Section 6662(b) are further named in regulations. Penalties cannot be "stacked" – only one penalty can apply to a given underpayment of tax.

The two transfer pricing penalties are part of the trio of penalties in the "substantial valuation misstatement" penalty under Chapter 1 of the Code (Normal taxes and surtaxes), introduced in Code Section 6662(b)(3) and described in Code Section 6662(e) and in Treasury Regulation Sections 1.6662-5 & 6. The 20% penalty is imposed under Code Section 6662(a) if tax underpayments exceed certain thresholds (described below). Subsection 6662(h) doubles the penalty (to 40%, called a "gross valuation misstatement penalty") if the tax underpayments exceed doubled upper, or halved lower, thresholds (described below).

The transactional penalty

The first transfer pricing penalty (the "transactional penalty" described in Code Section 6662(e)(1)(B)(i)) applies if the tax-return-reported price for any property or services, on a transaction-by-transaction basis, is 200% or more, or 50% or less, than the correct Code Section 482 price. For the corresponding gross valuation misstatement penalty, replace 200% with 400% and 50% with 25%.

The net Section 482 transfer pricing adjustment penalty

The second transfer pricing penalty (called either the "net Section 482 transfer pricing adjustment penalty" or the "net adjustment penalty" described in Code Section 6662(e)(1)(B)(ii)) turns on the amount of the "net Section 482 transfer price adjustment" – in essence, the aggregate of all Code Section 482 adjustments for a given taxable year – defined in Code Section 6662(e)(3)(A) as "the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under Section 482 in the price for any property or services (or for the use of property)". The net Section 482 transfer pricing adjustment penalty applies if the net Section 482 transfer pricing adjustment exceeds the lesser of USD5 million or 10% of the taxpayer's gross receipts. For the corresponding gross valuation misstatement penalty, replace USD5 million with USD20 million and 10% with 20%.

Defending against transfer pricing penalties

Code Section 6664(c)(1) provides in general that no penalty shall be imposed under Code Section 6662 with respect to any portion of an underpayment of tax if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion (the "Reasonable Cause & Good Faith Exception"). A substantial body of case law addresses the Reasonable Cause & Good Faith Exception, but almost none of it arose in the context of transfer pricing penalties.

Code Section 6662(e)(3)(B) excludes from the penalty threshold determinations, for the net Section 482 transfer pricing adjustment penalty, any portion of the increase in taxable income attributable to any redetermination of price if the taxpayer meets three requirements, which depend on whether or not the taxpayer used a specified transfer pricing method. If the taxpayer used a specified transfer pricing method, then Code Section 6662(e)(3)(B)(i) requires that:

- the taxpayer's use of the method was reasonable;
- the taxpayer has documentation on its application of the method; and
- the taxpayer gives the documentation to the IRS within 30 days of a request.

Treasury Regulation Section 1.6662-6(d) greatly expands on the documentation needed to demonstrate compliance with Code Section 6662(e)(3)(B). Subparagraph 6662(e)(3)(D) overrides application of the Reasonable Cause & Good Faith Exception to impose a net Section 482 transfer pricing adjustment penalty unless the taxpayer meets the requirements of Code Section 6662(e)(3)(B).

The Reasonable Cause & Good Faith Exception applies to prevent imposition of the transactional penalty. Treasury Regulation Section 1.6662-6(b)(3) provides, however, that if a taxpayer meets the Section 1.6662-6(d) requirements with respect to a Code Section 482 allocation, the taxpayer is deemed to have established reasonable cause and good faith with respect to the item for penalty protection purposes. Thus a taxpayer meeting the requirements of Section 1.6662-6(d) is protected against either transfer pricing penalty.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Treasury Regulation Section 1.6038-4 – titled "Information returns required of certain United States persons with respect to such person's US multinational enterprise group" – provides that certain US persons that are the ultimate parent entities of US multinational enterprise (US MNE) groups with annual revenue for the preceding reporting period of USD850 million or more, are required to file Form 8975.

Form 8975 and Schedule A are used by filers to report certain information annually with respect to the filer's US MNE group on a country-by-country basis. The filer must list the US MNE group's constituent entities, indicating each entity's tax jurisdiction (if any), country of organisation and main business activity, and provide financial and employee information for each tax jurisdiction in which the US MNE does business. The financial information includes revenues, profits, income taxes paid and accrued, stated capital, accumulated earnings and tangible assets other than cash.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

There is broad alignment of US transfer pricing rules under Code Section 482 with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "TP Guidelines"). In 2007 in formal guidance, the IRS signalled its belief that Code Section 482 and its associated Treasury regulations were "wholly consistent with... the OECD Transfer Pricing Guidelines", and the 2022 United States Transfer Pricing Country Profile provided to the OECD, states that "US transfer pricing regulations are consistent with the [Transfer Pricing Guidelines]".

Both the Code Section 482 Treasury regulations and the TP Guidelines have subdivisions broadly dealing with the arm's length standard/principle, transfer pricing methods, comparability, intangibles transfers, services and cost sharing arrangements/cost contribution arrangements. The TP Guidelines go further in certain respects, however, such as by including subdivisions addressing administrative approaches to avoiding and resolving transfer pricing disputes (Chapter IV); documentation, including the three-tiered approach (master file, local file and country-by-country reporting) (Chapter V); and transfer pricing aspects of business restructurings (Chapter IX).

9.2 Arm's Length Principle

It is challenging to answer the question of whether there are any circumstances under which US transfer pricing rules depart from the arm's length principle. US transfer pricing rules use the concept of the "arm's length standard" rather than the "arm's length principle". The standard is not found in Code Section 482, but cases addressing the statute and its predecessor have held the standard to be fundamental in the application of the statute. Section 1.482-1 of the Treasury regulations provides that, in determining the true taxable income of a controlled taxpayer, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with a controlled taxpayer". The regulation continues that "[e]valuation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in Section 1.482-1(c)".

US transfer pricing rules provide a range of specified methods for determining arm's length consideration in controlled transactions. While there is no formal hierarchy, the CUT method is paramount in the intangibles context in the sense that pricing determined using such method is immune from adjustment under the CWI standard under certain circumstances. The transfer pricing rules do not nominally depart from the arm's length principle, but one way they do depart from it is in the context of cost sharing arrangements, governed by Section 1.482-7. There, whether or not such an arrangement is considered arm's length is determined solely by whether the arrangement meets the requirements of the regulation (ie, Section 1.482-7 redefines the arm's length standard). Another way the transfer pricing regulations depart from the arm's length standard is that they allow certain services to be priced at cost (with no profit element) if the taxpayer complies with the applicable rules.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

See **9.4 Impact of BEPS 2.0**.

9.4 Impact of BEPS 2.0

The IRS believes the transfer pricing rules under Code Section 482 and its implementing Treasury regulations are consistent with the TP Guidelines but there is a belief among tax practitioners that differences exist. Any such differences are likely to manifest themselves in APA or MAP proceedings under US tax treaties with countries whose transfer pricing rules follow the TP Guidelines.

9.5 Entities Bearing the Risk of Another Entity's Operations

One party to a controlled transaction can bear the risk of the other party to the controlled transaction's operations by guaranteeing the other party a return, but the risk-bearing party must be appropriately compensated for the risk it bears. US regulations provide that contractual risk allocations will be respected if the terms are consistent with the economic substance of the underlying transactions. Comparison of risk bearing is also important in determining the degree of comparability between controlled and uncontrolled transactions.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The UN Practical Manual on Transfer Pricing (the "UN Manual") does not have a significant impact on transfer pricing practice or enforcement in the

United States. While the UN Manual may be a reference point for US transfer pricing matters in which the counterparty country relies on the UN Manual more substantially, Code Section 482, its implementing Treasury regulations, US case law and, where relevant, the TP Guidelines are the primary authorities for US transfer pricing practice and enforcement.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

The United States transfer pricing rules do not have safe harbours for transactions deemed immaterial or for taxpayers of a certain size. But the rules do contain isolated safe harbours that apply to certain types of transactions. Chief among them is the services cost method (SCM), a specified transfer pricing method that permits (but does not require) a taxpayer to charge out certain "covered services" at cost (ie, with no mark-up/profit element).

Covered services eligible for the SCM include specified covered services (ie, those on a list published by the IRS, which includes services such as IT, HR and finance) and low-margin services (those for which the median comparable mark-up on total costs is 7% or less). A service is not eligible for the SCM if it is on a list of excluded activities contained in a regulation (eg, manufacturing, research and development, and distribution). In addition, to qualify for the SCM, a taxpayer must reasonably conclude in its business judgement that the activity does not contribute significantly to key competitive advantages or fundamental risks of success or failure. The IRS generally defers to taxpayers with respect to the so-called "business-judgement" prong of the SCM.

Another isolated safe harbour relates to loans. The applicable rules provide for safe harbour interest rates for bona fide debts denominated in US dollars where certain other requirements are met.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

The US transfer pricing rules address location savings under the regulations that deal with comparability. The location savings rule is not specific to savings that arise from operating in the United States – it applies generally to determine how to allocate location savings between a US company and an affiliate operating in a lower-cost locale. The rule looks to hypothetical bargaining power and provides that the affiliate in the lower-cost locale should keep a portion of the location savings if it is in a position to bargain for a share of the location savings (ie, if there is a dearth of suitable alternatives in the low-cost locale or similar low-cost locales).

11.3 Unique Transfer Pricing Rules or Practices

The US does not have special rules that disallow marketing expenses by local licensees claiming local distribution intangibles. Rules that were once unique to the US, such as the CWI rule that allows the IRS to make after-the-fact adjustments based on actual results in the case of an intangibles transfer lasting more than one year, are becoming more common as other tax authorities focus on hard-to-value intangibles.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

The US requires a certain level of co-ordination between transfer pricing and customs valuation. Code Section 1059A and the Treasury regulations thereunder look to ensure that, when any tangible property is imported into the United States in a related-party transaction, the importer cannot claim a higher tax basis on its imported merchandise for income tax purposes than the value it claimed for the purpose of its customs obligations. In other words, the related-party importer generally cannot claim that the value of the property for transfer pricing purposes under Code Section 482 is higher than the value of the property for the purpose of paying customs duties in the United States.

The Code and Treasury regulations recognise, however, that there may be differences in value that are appropriate once specific methods and factors are taken into account. Among those factors are freight charges; insurance charges; the construction, erection, assembly, or technical assistance provided with respect to the property after its importation into the United States; and any other amounts that are not taken into account in determining the customs value, are not properly included in the customs value, and are appropriately included in the cost basis or inventory cost for income tax purposes. This last factor typically allows a taxpayer to demonstrate how its transfer price of the imported good accords with the arm's length standard required under Code Section 482, and why any difference between that arm's length value and the customs value is in accord with its obligations under Code Section 1059A.

This is an area that continues to confound taxpayers and the tax and customs authorities, which are not as co-ordinated as they would like. Taxpayers should carefully consider these tax and customs obligations.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

The US transfer pricing controversy process comprises audit, administrative appeals and judicial phases.

- Audit – US transfer pricing audits can be long and intensive, involving hundreds of information requests and dozens of interviews. In the event a taxpayer does not agree with an audit adjustment proposed by the IRS, the taxpayer generally has the right to pursue an administrative appeal. The examination team will issue a letter that gives the taxpayer 30 days to contest the adjustment by filing a protest to be considered by the IRS Independent Office of Appeals. Alternatively, a taxpayer can head straight to litigation.
- Administrative appeal – the IRS Independent Office of Appeals handles administrative appeals of audit adjustments in transfer pricing and other cases. Appeals officers will consider the examination file, the taxpayer's protest, and the IRS examination team's rebuttal. The Office of Appeals will then conduct one or more conferences with the aim of settling the dispute. Appeals officers are instructed to account for the probable results in litigation and settle cases based on the "hazards of litigation". A taxpayer unable to resolve its dispute with the IRS Independent Office of Appeals can proceed to court.

- Judicial process (trial and appeal) – a taxpayer can generally litigate a transfer pricing case in the US Tax Court, a federal district court, or the Court of Federal Claims. The US Tax Court is the only prepayment forum (ie, the only court in which the taxpayer can litigate without first paying the disputed tax and suing for a refund). The federal district courts and the Court of Federal Claims hear refund suits. In the narrow context of taxpayers in bankruptcy, transfer pricing disputes can be addressed prior to payment.

Taxpayers and the government can appeal trial court decisions to the federal appellate courts. US Tax Court and federal district court decisions are appealable to the 12 regional circuit courts of appeals. Court of Federal Claims decisions are appealable to the US Court of Appeals for the Federal Circuit. Appellate court decisions can be petitioned to the US Supreme Court, which has discretion as to whether to grant a review (and which does so in relatively few cases).

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Judicial precedent on transfer pricing in the US is fairly well developed. But transfer pricing cases are facts-and-circumstances dependent, which makes it difficult to rely too heavily on precedent from one case to the next.

14.2 Significant Court Rulings

There have been a number of important transfer pricing court cases in the United States. Select opinions in those cases are summarised below.

- 3M Co & Subs v Commissioner (2023 (US Tax Court) – still active): The Tax Court ruled 9–8 in an opinion reviewed by the full Tax Court that the Treasury regulation addressing foreign payment restrictions is valid and that the taxpayer failed to satisfy the requirements of that regulation. As a consequence, the Tax Court imposed a royalty adjustment based on the parties' stipulated arm's length royalty rate. 3M appealed the Tax Court's decision. The case is currently before an appeals court.
- Eaton Corp & Subs v Commissioner (2013, 2017, 2019 (US Tax Court); 2022 (6th Circuit)): In connection with the IRS's cancellation of two APAs, the US Court of Appeals for the Sixth Circuit, affirming in part and reversing in part the prior Tax Court decisions, held (i) consistent with contract-law principles, the IRS has the burden of proof to show it is permitted to cancel the agreement under the terms of the APA; (ii) the IRS may only cancel an APA on the limited set of grounds listed in the relevant revenue procedure, which the IRS failed to prove; (iii) the taxpayer's post-return self-corrections to comply with the APA are Code Section 482 adjustments; and (iv) the taxpayer may obtain double-tax relief through the relevant revenue procedure since the self-corrections were Code Section 482 adjustments.
- The Coca-Cola Co v Commissioner (2020 and 2023 (US Tax Court) – still active): The Tax Court ruled that the IRS was not arbitrary and capricious in applying the comparable profits method with the return on assets profit level indicator to allocate income from six foreign affiliates to the US parent. In so doing, the Tax Court did not allow the taxpayer to argue based on the substance of the controlled transactions. The Tax Court allowed the taxpayer to offset against its royalty obligations amounts paid historically as dividends in satisfaction of a pricing method previously agreed between the taxpayer and the IRS.

The Tax Court subsequently applied its 3M ruling and found against the taxpayer on the issue of whether the IRS could make transfer pricing adjustments that resulted in royalty payments in excess of those permitted by Brazilian law. The taxpayer has indicated an intent to appeal the Tax Court's decision in the case.

- Medtronic, Inc v Commissioner (2016 (US Tax Court); 2018 (8th Circuit); 2022 (US Tax Court) – still active): The Tax Court revised its earlier opinion after the 8th Circuit remanded for lack of sufficient development and analysis in applying the Tax Court's own transfer pricing method based on the taxpayer's CUT methodology. In its second opinion, the Tax Court rejected both the taxpayer's original CUT and the IRS's comparable profits method (CPM), and determined that the best method required the use of an unspecified method. The IRS appealed the Tax Court's decision, and the taxpayer then cross-appealed. The case is currently before an appeals court.
- Amazon.com, Inc v Commissioner (2017 (US Tax Court); 2019 (9th Circuit)): The Tax Court ruled that the IRS's application of the income method to price a cost sharing buy-in was arbitrary, capricious or unreasonable. The Tax Court agreed with the taxpayer that the IRS had wrongly included non-compensable goodwill and going-concern value in its adjustment. The US Court of Appeals for the Ninth Circuit agreed with the taxpayer and affirmed the Tax Court decision, rejecting the IRS's argument that goodwill and going-concern value were compensable under the then-existing regulations (which have since been amended).
- Altera Corp v Commissioner (2015 (US Tax Court); 2018 (9th Circuit)): The Tax Court sided with the taxpayer and invalidated a regulation that required parties to a cost sharing agreement to share the costs of stock-based compensation. A divided US Court of Appeals for the Ninth Circuit reversed and upheld the regulation.
- Bausch and Lomb, Inc v Commissioner, (1989 (US Tax Court); 1991 (2nd Circuit)): The Tax Court sided with the taxpayer and rejected the IRS's attempt to collapse a licence of technology and subsequent sale of contact lenses and treat a licensee as a contract manufacturer. The US Court of Appeals for the Second Circuit affirmed.
- Hospital Corporation of America v Commissioner (1983 (US Tax Court)): The Tax Court held that a business opportunity is not property and respected a transaction in which a foreign affiliate entered into a contract that the US parent could have entered into itself. The Tax Court proceeded to make substantial income allocations based on the US parent's contributions to the foreign business.
- B Forman Co v Commissioner (1970 (US Tax Court); 1972 (2nd Circuit)): The Tax Court sided with the taxpayer and required technical control for the transfer pricing rules to apply. The US Court of Appeals for the Second Circuit reversed and endorsed a flexible "acting in concert" test. That IRS-favourable standard was then incorporated in the transfer pricing regulations.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

With the potential exception of targeted economic sanctions programmes (ie, embargoes), the US does not restrict outbound payments relating to uncontrolled transactions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

The US does not restrict outbound payments relating to controlled transactions. But the US instituted a base erosion and anti-abuse tax in 2017 that targets outbound payments in controlled transactions that strip earnings out of the US through deductible payments. Some have suggested that the tax should be repealed because it is easily avoidable and has not raised substantial revenue.

15.3 Effects of Other Countries' Legal Restrictions

The US regulation regarding the effects of other countries' legal restrictions is being challenged in court. The regulation provides that the IRS will respect a foreign legal restriction only if certain requirements are met. Chief among those requirements is that the foreign legal restriction must be publicly promulgated and generally applicable to uncontrolled taxpayers in similar circumstances. The regulation also requires that:

- the taxpayer must exhaust all remedies provided by foreign law for obtaining a waiver;
- the foreign legal restriction must expressly prevent payment of part or all of the arm's length amount in any form (eg, by payment of a dividend); and
- the related parties must not have circumscribed or violated the foreign legal restriction in any way (eg, by arranging for an intermediary to pay on behalf of the controlled payer).

The regulation provides another difficult-to-satisfy avenue for compelling the IRS to respect a foreign legal restriction – if a taxpayer can demonstrate that the foreign legal restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. As noted in **14.2 Significant Court Rulings**, the Tax Court upheld the regulation in 3M Co & Subs v Commissioner. Its ruling in that case is now on appeal. The same issue is also presented in The Coca-Cola Co v Commissioner, in which the Tax Court also ruled against the taxpayer on the issue. The taxpayer in that case has also indicated an intent to appeal.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Pursuant to the Ticket to Work and Work Incentives Improvement Act of 1999, Congress required the IRS to publish an annual report on its APA programme. The first report covered the period from the APA programme's inception in 1991 through to 1999, and the IRS has published annual reports every year since. The annual reports provide substantial data and other information on APAs during the covered years, including:

- the number of APA applications filed in total and, for bilateral APAs, by foreign country;
- the number of APAs executed in total and, for bilateral APAs, by foreign country;
- the number of APA applications pending in total and, for bilateral APAs, by foreign country;
- the number of APAs revoked or cancelled and APA applications withdrawn;
- the number and percentage of APAs executed by industry and certain sub-industries;
- the nature of the relationships between the controlled parties in executed APAs;
- the types of covered transactions in executed APAs;
- the types of tested parties in executed APAs;

- the transfer pricing methods used in executed APAs;
- the sources of comparables, comparable selection criteria and the nature of adjustments to comparables or tested party data in executed APAs;
- the use of ranges, goals and adjustment mechanisms in executed APAs;
- the use of critical assumptions in executed APAs;
- the term lengths of executed APAs;
- the amount of time taken to complete new and renewed APAs; and
- post-execution efforts to ensure compliance with an APA and ensure the adequacy of required annual documentation under an APA.

There are no similar publicly available reports on IRS transfer pricing audit or administrative appeal outcomes.

16.2 Use of "Secret Comparables"

There is no evidence that the United States relies on secret comparables for transfer pricing enforcement. If the IRS asserts a transfer pricing adjustment at the end of an audit, then the IRS will provide the taxpayer with a written report in which it discloses any comparables on which it is relying to justify its adjustment. Similarly, in litigation, the IRS will provide one or more expert witness reports detailing the IRS's transfer pricing analyses and the bases for them.

In the APA context, the annual report required by Congress (see **16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes**) specifies the sources of comparable data on which APMA relies, with the list generally composed of publicly available databases.

Trends and Developments

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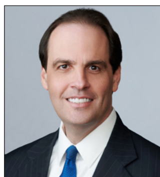
Gibson Dunn & Crutcher is a full-service international law firm that advises on some of the most significant transactions and complex litigation around the world. Consistently achieving top rankings in industry surveys and major publications, Gibson Dunn & Crutcher is distinctively positioned in today's global marketplace, with more than 1,800 lawyers and 20 offices, including Abu Dhabi, Beijing, Brussels, Century City, Dallas, Denver, Dubai, Frankfurt, Hong Kong, Houston, London, Los Angeles, Munich, New York, Orange County, Palo Alto, Paris, San Francisco, Singapore and Washington, DC. Gibson, Dunn & Crutcher's global tax controversy and litigation group represents multinational corporations, privately held companies, investment funds, partnerships, sovereign wealth funds and individuals in resolving a broad range of complex domestic and cross-border tax disputes. It works with clients at all stages of tax controversy, ranging from audit and administrative resolution through to trial court proceedings and judicial appeals. The tax controversy and litigation lawyers work closely with the firm's market-leading corporate, commercial litigation, intellectual property, appellate and other practices in a variety of contexts.

Authors



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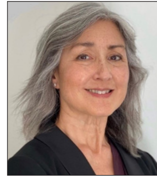

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Introduction

Transfer pricing in the United States is governed primarily by the extensive set of Treasury regulations promulgated under Internal Revenue Code Section 482. Following substantial revisions to those regulations in the 1990s and earlier in the 2000s, they have remained largely unchanged for nearly a decade. Certain ancillary Treasury regulations have changed to reflect implementation of the Tax Cuts and Jobs Act of 2017, but the regulations under Section 482 have remained constant. What has evolved over the past decade, however, are the US Internal Revenue Service's (IRS's) efforts at heightened transfer pricing enforcement under those regulations, and, collaterally, heightened transfer pricing enforcement by taxing authorities at the state level. This chapter summarises some of the more notable elements of those enhanced enforcement initiatives.

The Transfer Pricing Audit Process

An important development in United States transfer pricing over the past few years has been the IRS's increased focus on the use of standard practices and processes in all transfer pricing audits. Those efforts prompted the IRS Large Business & International Division (LB&I) to issue a Transfer Pricing Audit Roadmap (the "Roadmap") in 2014. LB&I replaced the Roadmap in 2018 with a document titled the "Transfer Pricing Examination Process" (TPEP), which was most recently revised in September 2020. LB&I has stated its intent to update the TPEP publication regularly based on feedback from examiners, taxpayers and practitioners. The TPEP publication is more detailed and comprehensive than the prior Roadmap. In 2023, the IRS updated the Internal Revenue Manual, a document that guides IRS personnel when administering the income tax laws, to incorporate the TPEP.

One of the main highlights of the TPEP publication is that it divides transfer pricing audits into three phases:

- the planning phase;
- the execution phase; and
- the resolution phase.

The planning phase

The planning phase involves internal IRS coordination and review of taxpayer documents (including annual reports, tax returns, and the country-by-country report) and the preparation of ratio analyses to determine "whether cross-border income shifting is occurring". The IRS then develops a preliminary working hypothesis and risk analysis before scheduling an opening conference with the taxpayer. The fact that the IRS is engaged in analysing taxpayers' transfer pricing and deciding whether income shifting has occurred without meaningful taxpayer input has worried taxpayers and practitioners.

The execution phase

The execution phase resembles a transfer pricing audit before the TPEP. The IRS issues information requests and develops the facts. The IRS is supposed to meet periodically with the taxpayer to confirm relevant facts. And the IRS should update its risk assessment continuously to determine which issues will continue to be examined. The IRS is also supposed to issue a so-called acknowledgement of facts (AOF) information request at the end of the execution phase. The purpose of the AOF information request is to have the taxpayer confirm (or supplement) the facts that the IRS believes it has developed during the audit and on which the IRS will base transfer pricing adjustments. The idea behind this is to lock down the facts before the IRS proposes transfer pricing adjustments so that the administrative appeals process is

based on an agreed set of relevant facts. The IRS may issue additional information requests after receiving a taxpayer's AOF response.

The resolution phase

The resolution phase involves an attempt to reach agreement with the taxpayer before the IRS issues a document that affords the taxpayer the right to pursue an administrative appeal or the opportunity to pursue mutual agreement procedures (MAPs) under applicable US tax treaties. The IRS is also supposed to consider early resolution tools, including referring the case for mediation under a special programme called Fast Track Settlement.

Audit timelines

The TPEP publication does not mandate any specific audit timeline. It contains two exhibits with examples of transfer pricing examinations (which include time for administrative appeals and MAP processes) – one spanning 24 months and the other spanning 36 months. The TPEP publication specifies that the sample timelines should only be used as guides and that every examination plan's timeline should be adapted to the particular case.

The TPEP publication is an important development in the US transfer pricing landscape that reflects the IRS's continued focus on standardising transfer pricing audits. Taxpayers and practitioners should familiarise themselves with the document and consider accepting the IRS's invitation to provide feedback in order to improve the transfer pricing audit process.

Increased Involvement of the US Competent Authority in Transfer Pricing Audits

In 2019, LB&I issued memorandum LB&I-04-0219-001, which mandates that LB&I examination teams consult with members of the IRS Advance Pricing and Mutual Agreement Program (APMA) on procedural and substantive matters regarding potential transfer pricing adjustments involving countries with which the United States has a tax treaty. Although the memorandum has an expiration date of 18 February 2021, it continues to reflect LB&I's apparent practice.

US tax treaties designate the Secretary of the Treasury or his delegate as the US "competent authority". That authority, in turn, has been delegated to the directors of Transfer Pricing Operations (TPO, subsequently renamed Treaty & Transfer Pricing Operations or TTPO) and APMA. TTPO is an organisation within LB&I, and APMA is an organisation within TTPO. The US competent authority has authority to apply the provisions of US tax treaties.

Transfer pricing issues arise under Article 9 ("associated enterprises") of US tax treaties, and these issues compose a substantial portion of both the US competent authority's caseload and LB&I's taxpayer examination inventory.

The MAP articles of US tax treaties give a taxpayer the right to ask for assistance from the US competent authority if the taxpayer believes that the actions of the US or a treaty country have resulted, or will result, in the taxpayer being subject to taxation not in accordance with the applicable US tax treaty. This situation can arise, for example, if LB&I examiners propose a transfer pricing adjustment that increases the income of a US parent corporation with respect to a transaction with a foreign subsidiary corporation that is a tax resident of a country with which the US has a tax treaty. Unless the foreign subsidiary gets a correlative tax deduction, double taxation arises.

The US parent corporation (or, under some tax treaties, the foreign subsidiary) can make a competent authority request. If the US competent authority accepts the request, it will try to resolve the issue through consultations with the applicable foreign competent authority, but in some cases it may resolve the issues unilaterally. In the above example, the US parent corporation can make a competent authority request when it gets a written notice of proposed adjustment from LB&I examiners. This is important because the US competent authority assumes exclusive jurisdiction within the IRS if the US competent authority accepts a request; that is, LB&I examiners and/or IRS Appeals lose jurisdiction.

The US competent authority is likely to take a holistic view of the proposed transfer pricing adjustment; in particular, to what extent the proposed adjustment would be perceived as being at arm's length under the transfer pricing rules of the foreign country. The US competent authority can modify, or even eliminate, the LB&I examiners' proposed adjustment if it believes that treatment is warranted to relieve double taxation.

The mandate in the 2019 LB&I memorandum signals, on the one hand, that sharing of information and experience by APMA with LB&I examiners is intended to give examiners "useful information for consideration in their selection and development of transfer pricing issues". But the memorandum also clarifies that examiners are ultimately responsible for selecting and developing issues and should retain "an appropriate degree of independence... from the competent authority process".

For examinations opened after 30 September 2017, approval from the Transfer Pricing Review Panel (TPRP) is required where the LB&I examiners believe the taxpayer's chosen method (as reflected in the taxpayer's Section 6662 transfer-pricing documentation) does not reflect arm's length results. The LB&I examiners seek approval to change the taxpayer's transfer pricing method by filing a specified form together with documentation (that includes work papers and a draft report or any other format that is clear and concise) with the issue team manager and territory manager for approval. If approved, the material is submitted to the Director of Field Operations of the Transfer Pricing Practice (TPP DFO) for approval before it is uploaded to a SharePoint site for review by the TPRP.

The TPRP generally consists of the TPP DFO or APMA director (depending on whether the case is an examination case or an APA programme case), a senior adviser to the TTPO director, and the TPPO manager. The TPRP meets on an ad hoc basis and anticipates meeting at least bi-monthly. The TPRP review process is supposed to be completed within 60 days of a submission to the TPRP. The process is a purely internal one. Taxpayers have no ability to participate and are advised to address any concerns through the normal examination process.

An interesting dynamic could develop in the IRS process for making transfer pricing adjustments in situations involving treaty-partner countries. According to the 2019 memorandum, APMA involvement is only intended to influence LB&I examiner behaviour, and not the other way around. It remains to be seen whether the sharing of information and experience by APMA with LB&I examiners means the examiners are less likely to make transfer pricing adjustments that would be modified or entirely rejected by the US competent authority.

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Change in the Way the IRS Audits Large US Corporate Taxpayers: Revenue Procedure 94-69 Replaced by Revenue Procedure 2022-39

Revenue Procedure 94-69 allowed certain taxpayers to disclose additional income for a year under audit to prevent the imposition of penalties under Section 6662 of the Internal Revenue Code. For examinations beginning after 16 November 2022, a new disclosure procedure, Revenue Procedure 2022-39, applies.

The imposition of penalties under Section 6662 turns on whether there has been a sufficiently large underpayment of tax. An underpayment of tax generally means the excess of income tax successfully imposed by the IRS over "the amount shown as the tax by the taxpayer on his return". This latter amount includes not only the amount shown on the taxpayer's original return but also any amount shown as additional tax on a qualified amended return (QAR). Disclosing additional tax on a QAR can eliminate the risk that a Section 6662 penalty will be imposed. A QAR includes an amended return filed after the due date of the return for the taxable year, but it must be filed before the taxpayer is first contacted by the IRS concerning an examination of the original return for that year.

This timing requirement was troublesome for large taxpayers that were subject to audit under the Coordinated Industry Case (CIC) programme. CIC programme taxpayers included all domestic corporations over a certain size. CIC programme taxpayers were under continuous audit and therefore arguably could not meet the timing requirement for filing a QAR.

But the relevant regulations allow the IRS by revenue procedure to prescribe the way the QAR rules "apply to particular classes of taxpayers".

To alleviate the inequity faced by CIC taxpayers, the IRS issued Revenue Procedure 94-69, which allowed such taxpayers to file a written statement with their examination team within a certain period near the start of an exam. The written statement was treated as a QAR. CIC taxpayers could thus reduce their risk of having penalties imposed by disclosing amounts of tax due in this manner.

In 2019, the IRS announced a replacement of the CIC programme with the Large Corporate Compliance (LCC) programme. The LCC programme replaces automatic examination of every return within the CIC programme with a method for selecting returns by using data analytics "to identify the returns that pose the highest compliance risk". LB&I withdrew Revenue Procedure 94-69 after the LCC programme replaced the CIC programme because, unlike the CIC programme, the LCC programme is not necessarily a continuous examination programme. LB&I became concerned that Revenue Procedure 94-69 created an advantage for LCC taxpayers over other taxpayers that are required to use the "normal" QAR process.

Many former CIC taxpayers asserted that, under the LCC programme, they would likely continue to find themselves under near-continuous audit because large corporate taxpayers tend to have more complex issues and transactions that the IRS could identify as carrying higher compliance risks. In response, the IRS refined its position by issuing Revenue Procedure 2022-39.

Under Revenue Procedure 2022-39, if the IRS has audited (or is auditing) the taxpayer (corporation or partnership) for at least four of the five preceding taxable years under the LCC or CIC programme (or the Large Partnership Compliance Program or a successor programme), then

the taxpayer can submit a Form 15307, Post-filing Disclosure for Specified Large Business Taxpayers, to the IRS examiner within 30 days of a request, which the IRS will treat like a QAR.

APMA's Growing Role

As noted above, the referenced 2019 LB&I memorandum portends an increased role for APMA in LB&I transfer pricing audits involving affiliates and transactions in treaty-partner countries. APMA's increasing role in the audit context is consistent with its increasing presence in transfer pricing enforcement through the channels for which it has more direct responsibility: advance pricing agreements (APAs) and MAPs.

Since its creation in 2012 with the merger of the previously separate APA programme and the portion of the US competent authority office charged with resolving transfer pricing disputes under the United States' bilateral income tax treaty network, APMA has become an increasingly significant presence in the US transfer pricing enforcement landscape. Data bears this out. APMA has concluded more APAs every year on average since 2012. Likewise, APMA's MAP inventory has grown substantially since APMA's first year. Approximately two thirds of the cases in APMA's MAP inventory are transfer pricing cases.

APMA's workloads in the APA and MAP realms are expected to continue to grow. Increasingly aggressive transfer pricing enforcement efforts by jurisdictions around the world, combined with the potential impacts of the OECD's ongoing two-pillar attempt to address global tax challenges, suggest an ever-increasing role for APAs for taxpayers desiring advance certainty, and likewise, an increasing role for the MAP process for taxpayers seeking to avoid double-tax consequences from audit adjustments.

Faced with a growing case inventory, LB&I issued a memorandum in 2023 containing instructions that could deter some taxpayers from filing APA requests. That memorandum provides that LB&I examiners will be involved in the initial assessment of APA requests, which was not the case in the past. The memorandum also indicates that the OECD's International Compliance Assurance Programme (ICAP) might be a better vehicle than an APA for addressing a taxpayer's transfer pricing issues. Although the memorandum indicates that it is not intended to decrease the number of APA requests, taxpayers are concerned that LB&I examiners' involvement in the APA review process could lead to more joint audits or to examiners advocating that taxpayers go the ICAP route rather than seeking APAs.

Transfer Pricing Across the United States: the Focus of the States on Transfer Pricing Enforcement

Individual state revenue agencies often look to interstate transactions among commonly controlled parties to determine how much income is properly "apportioned" to their state for the purposes of imposing state income and other taxes. Using various tools such as "nexus apportionment" and "forced combination" (to name a couple), states seek to ensure that they are taxing the activities conducted in their states and the income earned therefrom. Over the past several years, however, states have also been looking to transfer pricing and techniques based on those found in federal law to examine intercompany transactions between related companies across state borders in an attempt to combat perceived tax avoidance.

The aim of transfer pricing at the state level is similar to what it is internationally: to ensure that transactions between related parties for tangible and intangible goods and services are in accord-

ance with comparable transactions between unrelated parties. In the US, this is particularly relevant in so-called separate return states, where the activities of entities doing business in those states are taxed separately. Likewise, this is also important when considering intercompany transactions with foreign affiliates, as foreign affiliates are often excluded from state returns altogether.

In 2016, the Multistate Tax Commission (MTC), an intergovernmental state tax authority that was created to promote uniform and consistent tax policy and administration among the states, began giving significant attention to the issue of transfer pricing enforcement, creating the State Intercompany Transactions Advisory Service to provide transfer pricing training to state auditors. While the MTC effort did not gain significant support, it did reflect an effort by the states to increase their transfer pricing knowledge and audit capabilities using analogous state laws and authorities.

For example, various state revenue agencies have started dedicating significant resources to transfer pricing training and education to enhance enforcement efforts. A recent study indicated that nearly half of the states' revenue agencies have hired third-party transfer pricing experts, signed "exchange of information" agreements, and invested in "Section 482 training". Moreover, some states have been retaining outside counsel and transfer pricing experts to pursue their enforcement initiatives, including former US Treasury and IRS counsel personnel.

The past year witnessed significant events in the state transfer pricing realm. Highlights include a South Carolina judge's ruling against Tractor Supply Company in a transfer pricing case. The judge agreed with the state taxing authority that the markup on inventory that a Texas affiliate applied on sales to the corporate parent and an affiliate in Michigan shifted income from South Carolina retail sales to Texas and that combined unitary reporting, which eliminated the effect of the inventory markup and resulted in a larger taxable base to which South Carolina could apply its income tax rate, was warranted. Another highlight was Louisiana's large transfer-pricing suit against ConocoPhillips Co in which Louisiana alleged that the taxpayer shifted income out of Louisiana through the pricing of related party oil and gas transactions and intercompany services.

Taxpayers doing business in the US should continue to expect state revenue agencies to scrutinise their controlled transactions. With continuing budget challenges, states have begun utilising whatever tools they have available to maximise revenue and increase their collection coffers. To prepare, companies doing business in the US should ensure that they prepare and update their interstate transfer pricing studies and should be ready to face potential state transfer pricing challenges.

Increasing LB&I Audit Activity

LB&I has continued to expand audit efforts involving transfer pricing issues. This includes a recent initiative targeting US distribution subsidiaries of large foreign corporations that report recurring losses or low margins on US federal income tax returns. The IRS will receive substantial additional funding in the coming years, and there is reason to believe that a meaningful portion of those funds could be used to ramp up transfer pricing enforcement.

Increased Scrutiny of Economic Substance

In recent public statements, IRS officials have signalled an intent to invoke economic sub-

stance principles more frequently in the transfer-pricing context. The IRS has already done so in docketed litigation, including in Perrigo Co v United States, No 1:17-cv-00737 (W.D. Mich. 2021). In this case, the IRS argued that Perrigo's transfer to a foreign affiliate of rights to manufacture and distribute a pharmaceutical product in the United States lacked economic substance; the IRS asserts transfer pricing adjustments in the alternative. The case awaits a ruling.

Increased Potential for Penalty Assertions

LB&I has indicated that it intends to scrutinise taxpayers' annual transfer-pricing documentation more closely to determine whether penalties are warranted. The IRS has already begun asserting penalties in docketed transfer-pricing cases, even where taxpayers prepared annual documentation for the years involved. It appears that there will be increased penalty assertions in the coming years and US taxpayers would be well advised to pay closer attention to their transfer pricing documentation to minimise penalty risk.

Judicial Opinions

3M Co & Subs v Commissioner (2023) (US Tax Court – still active) – the Tax Court ruled 9–8 in an opinion reviewed by the full court that the Treasury regulation addressing when the IRS will respect foreign payment restrictions is valid and that the taxpayer failed to satisfy the requirements of that regulation. In so doing, the court rejected challenges on multiple administrative law grounds. The court distinguished precedent pre-dating the regulation at issue, including a Supreme Court decision. The dissenting judges raised a number of challenges to the court's opinion and would have invalidated the regulation. The case is currently on appeal.

Medtronic, Inc v Commissioner (2016 (US Tax Court); 2018 (8th Circuit); 2022 (US Tax Court) – still active) – following the 8th Circuit's reversal and remand of the Tax Court's prior decision, the Tax Court conducted a limited retrial after which it rejected both the taxpayer's application of the comparable uncontrolled transaction (CUT) method and the IRS's application of the comparable profits method (CPM). The court determined that the best method was an unspecified method that borrowed aspects of both parties' proposed pricing methods. The IRS appealed the Tax Court's decision. Medtronic then filed a cross appeal. The case is currently on appeal.

The Coca-Cola Co v Commissioner (2020 (US Tax Court) – still active) – the Tax Court rejected the taxpayer's application of the CUT method and ruled that the IRS was not arbitrary and capricious in applying the CPM with a return on assets profit level indicator to allocate income from six foreign licensees to the US licensor. Historically, the IRS has been unsuccessful in seeking to apply the CPM to price licensing transactions. The court also ruled for the IRS on Brazil-specific issues in 2023. The court applied the 3M ruling, as it was required to. The case presents a number of important issues, including the same regulatory validity issue in dispute in 3M, and remains subject to appeal.

Eaton Corp & Subs v Commissioner (2013, 2017, 2019 (US Tax Court); 2022 (6th Circuit)) – this case stemmed from the IRS's cancellation of two APAs based on the taxpayer's alleged material failures to comply with the terms of the APAs. The courts ultimately held that the IRS had improperly revoked the APAs without reaching the substantive transfer pricing questions presented. The taxpayer recently filed lawsuits that address substantive transfer pricing issues in later years.

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