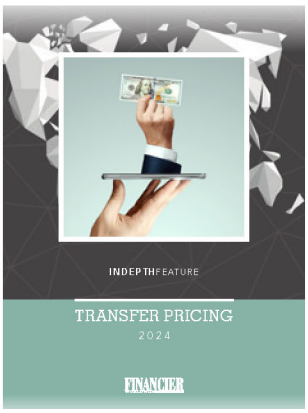

CAPLIN & DRYSDALE

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TRANSFER PRICING

Financier Worldwide canvasses the opinions of leading professionals around the world on the latest trends in transfer pricing.

UNITED STATES

Caplin & Drysdale

Respondent

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J. Clark Armitage is a member of Caplin & Drysdale. He served for eight years with the IRS APA Program and uses that experience to advise multinational corporations on transfer pricing matters. He also advises on other US international tax issues, including sourcing of income and expense, US trade or business issues, the US federal income tax implications of bona fide Puerto Rican residency and status under Puerto Rico Act 20, Act 22, Act 60, and Act 73, and issues arising under the Tax Cuts and Jobs Act of 2017, such as GILTI, FDII, BEAT and foreign tax credit basketing.

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Q. What do you consider to be the most significant transfer pricing changes or developments to have taken place in the US over the past 12 months or so?

A. The biggest development during the past 12 months was the 3M decision, in which the US Tax Court sustained the Internal Revenue Service (IRS) blocked income regulations. The case involved an IRS adjustment to royalty income earned by 3M US from a Brazilian subsidiary. Brazil limited by law the amount of the royalty and the parties agreed that an 'arm's length' royalty would be larger. The taxpayer took the position that the IRS blocked income regulations, by requiring an inclusion of income that could not legally be paid, conflicted with the US Supreme Court decision in *First Security Bank of Utah* and so are *ultra vires*. The IRS sought to enforce its regulations and require the full arm's length royalty inclusion on several bases, including that the Brazilian regulation applied only to the taxpayer and to royalties between related parties and was not publicly promulgated. In a 9-8 decision the Tax Court sided with the IRS and distinguished *First Security Bank of Utah* on the basis that the regulations then at issue included language requiring the taxpayer to have "complete power" over the money that could have been paid, while the regulations at issue in 3M had dropped that language. The case is on appeal.

Q. In your opinion, do companies pay enough attention to the challenges and complexities of maintaining compliant transfer pricing policies?

A. Companies generally do pay attention to their transfer pricing. They generally develop transfer pricing documentation for their most material transactions and establish reserves when there are areas of material uncertainty. Some judgment must be brought to bear on what to cover since covering all transactions, regardless of size and risk, could be prohibitively expensive.

Q. To what extent have the tax authorities in the US placed greater importance on the issue of transfer pricing in recent years, and increased their monitoring and enforcement activities?

A. For the past 15 to 20 years, the IRS has dedicated material resources to

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identifying large dollar transfer pricing adjustments and designating them for litigation. However, the IRS recently changed its audit practices regarding transfer pricing documentation. Instead of routinely requesting transfer pricing documentation at the start of an audit, the audit team now generally has discretion on whether to request documentation and whether to pursue a transfer pricing issue. Some audits – even of large multinationals – now do not involve transfer pricing components. It will be interesting to see if the IRS's shift on this issue portends less IRS attention to transfer pricing or causes taxpayers to reduce their focus on transfer pricing preparedness.

Q. Have you seen an increase in transfer pricing disputes between companies and tax authorities in the US?

A. The IRS has long focused its audits of large multinationals on transfer pricing. This focus may now be shifting. It remains to be seen, however, whether real change will occur.

Q. How should companies respond if they become the subject of a tax audit or investigation? What documentation needs to be made available in this event?

A. US rules allow taxpayers to choose whether to prepare transfer pricing documentation. A taxpayer that does generally will be protected from transfer pricing penalties – equal to 20 or 40 percent of the underpaid tax resulting from a transfer pricing adjustment, depending on the size of the adjustment. This documentation, and sometimes background documents, must be provided to the IRS within 30 days of a request for transfer pricing documentation or they will not protect the taxpayer from penalties. Once these documents have been produced, the taxpayer should gather its transfer pricing team, both in-house and external, to identify the likely focus of the IRS investigation and assess the exposure, if any. Transfer pricing audits generally move slowly, but not always. It is important to get ahead of the next set of IRS questions, if possible.

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Q. What kinds of challenges arise in calculating appropriate transfer prices, both for tangible and intangible assets? How crucial is it to have consistent supporting documentation?

A. Transfer pricing is an inherently uncertain subject. The taxpayer must assess the functions, assets and risks relevant to each transfer price, decide how important each party's contributions are, identify comparable transactions or companies for which data is available in the public sphere, compare the facts surrounding the tested transaction or party to the available public data, and identify and apply the most reliable method for pricing the transaction. For less valuable transactions and activities, a comparable profits method generally will be accepted by the IRS as the most reliable method. Beyond those types of activities, substantial uncertainty and wide potential ranges in pricing exist. As such, there are, practically speaking, ranges of arm's length ranges, depending on the taxpayer's selected method. For this reason, taxpayers appropriately focus their transfer pricing documentation on these non-routine activities and transactions.

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Q. In general, what advice would you give to companies on reviewing and amending their transfer pricing policies and structures?

A. Transfer pricing policies should be reviewed annually as part of the decision on whether to create transfer pricing documentation. Changes should be made as and when needed. Transfer pricing structures – meaning which entities participate in transactions and their contractual rights and obligations – generally change slowly and only if the legacy arrangements are no longer viable. There is a cost to changing transfer pricing arrangements – such as the potential for a US or foreign exit tax and retrospective audit risk. Taxpayers should and generally do tread carefully here. ❑

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