US Transfer Pricing Developments

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The Arm's-Length Standard

The arm's-length standard has served as the foundation of the world's transfer pricing for the last half century.

However, in for the past year, at least, it has been under significant attack as a result of the OECD's base erosion and profit shifting (BEPS) papers.

Arm's-length principles are based on what unrelated parties would agree to under similar circumstances. It is a simple concept that can be applied consistently. According to Treas. Reg. § 1.482-1(b)(1), the standard to be applied "in every case" under Section 482 is the arm's-length standard.

According to the OECD BEPS discussion drafts: "Special measures, either within or beyond the arm's-length principle, may be required with respect to intangible assets, risk and over-capitalisation", to address purported flaws in the transfer pricing system. The OECD is considering circumstances in which related-party contracts can, or should be, ignored under a "special measure". The concept of a "special measure" involves subjectivity and vagueness, which obscure the arm's-length standard.

A "special measure" by its very nature suggests a movement away from a consistent pricing methodology. It will be difficult to build a consensus among countries on the application and administration of "special measures". No country wants to lose revenue as a result of a transfer pricing "special measure".

The US Treasury, although it has its own discomfort with the arm'slength standard (as discussed below), is not supportive of the OECD's efforts. Robert Stack, deputy assistant secretary for international tax affairs with the US Treasury and the US delegate to the OECD, recently said the US wants a thorough discussion paper on the arm's-length principle that deals with how to price hard-to-value intangibles.

While the US supports the arm's-length standard internationally, domestically the IRS itself has sought to undermine the arm's-length standard in recent transfer pricing disputes and in the cost sharing regulations. In *Altera Corp. v. Commissioner*, T.C. Dkt Nos. 6253-12, 9963-12, the IRS asserts that unrelated party comparable data is irrelevant in determining whether parties to a cost sharing agreement must include stock-based compensation.

In *Xilinx v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), the IRS made the same argument and lost. As a result of the *Xilinx* case, the IRS revised Treas. Reg. § 1.482-7(d)(2) in 2003 to specifically require the cost sharing of stock-based compensation. The validity of that regulation is at issue in *Altera*.

Companies typically have provisions allowing them to adjust their cost sharing payments attributable to stock-based compensation in the event that the 2003 cost sharing regulations are held to be invalid, including Amazon.com. The *Altera* case will be critical to many companies.

Transfer Pricing Documentation Requirements

US businesses have become increasingly concerned about the rapidly growing transfer pricing documentation requirements utilised by governments around the globe. Transfer pricing compliance has become extremely costly for multinational corporations. This year, more than ever, companies have vocalised their concerns about the burdens and inefficiencies of the global transfer pricing requirements.

One of the BEPS action plan points seeks to modify the global rules to make transfer pricing compliance easier and more straightforward, while at the same time enhancing transparency. The goal is to create documentation standards that provide tax authorities with useful and more focused information. The slant of the OECD's discussion drafts, however, is strongly towards transparency at the cost of compliance.

BEPS' country-by-country (CbC) reporting is a part of this growing complexity. The OECD recently announced that it will reduce the number of required items in the originally proposed CbC reporting template. The original list of seventeen items has been reduced to seven. The seven CbC items include (1) revenues; (2) earnings before interest, taxes, depreciation and amortisation; (3) case taxes; (4) current-year tax accruals; (5) stated capital and accumulated earnings from the balance sheet; (6) number of

employees; and (7) tangible assets. However, this can still be enormously burdensome.

Moreover, another concern the US, and US companies, has with CbC reporting is how the information will be shared among tax authorities. US companies want to ensure that there is no public disclosure of trade secrets, scientific secrets, or other confidential information. Many tax advisers in the US are concerned that CbC reporting leads in the direction of formulary apportionment.

The language requirement for the local country filing is controversial and has yet to be resolved.

Section 482 Roadmap

Following a number of defeats in transfer pricing litigation, the IRS recently published its new "Transfer Pricing Audit Roadmap" on February 14 2014. The 482 roadmap is designed to provide audit techniques and tools to assist with the planning, execution and resolution of transfer pricing examinations. Sam Maruca, transfer pricing director, has expressed hope that the roadmap will result in less transfer pricing litigation.

The roadmap encourages open communication and cooperation with taxpayers, instructing exam to engage in up-front planning and to involve transfer pricing specialists at the earliest stage. The roadmap asserts that transfer pricing specialists can ensure that the audit timeline is appropriate given the complexity of the case, provide guidance regarding resources and staffing, and help determine which issues are not worth pursuing. The roadmap states that if the taxpayer's financial results are reasonable, the transfer pricing issue may not be worth pursuing.

Transfer pricing cases are usually won and lost on the facts. The key in transfer pricing cases, the roadmap explains, is to put together a compelling factual story based on a thorough analysis of functions, assets, and risks, and an accurate understanding of the relevant financial information. This advice is equally applicable to corporate taxpayers, of course.

One road block to the roadmap, however, may prove to be the IRS's recent new rules on information document requests (IDRs) used in IRS corporate tax examinations which likely will lead to the more frequent use and threatened use of summons to enforce IDRs.

Transfer Pricing Cases

3M Company v. Commissioner, T.C. Dkt. No. 5816-13, involves the IRS's allocation of royalty income from a Brazilian subsidiary to its US parent. The taxpayer asserts that the royalty is prohibited under Brazilian law and argues that the IRS does not have the authority to reallocate income if foreign law prohibits payment or receipt. Under different facts, the US Supreme Court has held that the IRS does not have such authority, which the IRS sought to overrule with regulations. The validity of this regulation, Treas. Reg. § 1.482-1(h)(2), is in issue.

Amazon.com, Inc. v. Commissioner, T.C. Dkt. 31197-12, involves cost sharing and valuing pre-existing intangible property. Amazon challenges the IRS's $3.4 billion transfer pricing adjustment. It involves the same issues that were litigated in *Veritas v. Commissioner*, 133 T.C. 297 (2009), *nonacq*, which is cited in Amazon's Tax Court petition.

BMC Software, Inc. v. Commissioner, 141 T.C. No. 5 (2013), involved the treatment of a secondary adjustment under section 965 (the one-time repatriation provision) by reason of a Rev. Proc. 99-32 election. The revenue procedure allows the taxpayer to repatriate an amount of its CFC's earnings, US tax-free, to the extent the income is allocated to the taxpayer from the CFC under § 482. An appeal of the case is pending in the Fifth Circuit. *BMC* has important transfer pricing ramifications since Rev. Proc. 99-32 is commonly used in transfer pricing adjustments.

Advance Pricing Agreement (Apa) Report

The IRS recently released its annual advance pricing agreement (APA) report covering the calendar year 2013. The number of executed APAs in 2013 (145) increased from the previous year (140). The number of executed APAs exceeded the number of APA applications for the second year in row as the IRS continues to work through its backlog of pending APA applications.

The number of applications received in 2013 decreased from 126 to 111. The termination of Eaton's APA may have had an impact on the number of APA applications. Two of Eaton's APAs were unilaterally cancelled by the IRS. Eaton argued in court that APAs are enforceable contracts. The IRS asserted that it has the authority to cancel APAs. In *Eaton Corp. v. Commissioner*, 140 T.C. No. 18 (2013), the Tax Court held for the IRS on cross motions for summary judgment.

The median completion time for an APA decreased by seven months, to just under three years (32.7 months). The IRS has been trying to improve APA processing time. However, the median time to complete new bilateral APAs is still over three years (38.8 months).

As with prior years, inbound APAs involving foreign parent companies and US subsidiaries accounted for more than half of the APAs (55%). The large majority of bilateral APAs involved Japan (53%). The other separately listed countries were Canada (19%), the UK (8%) and Australia (5%). It is interesting that just four countries accounted for such a large majority (85%) of all US bilateral APAs. All other countries combined only accounted for just 15%.

A substantial number of the APAs involved the comparable profits method (CPM)/transaction net margin method (TNMM) (77%). The TNMM is used in Japan and is similar to the CPM, which is frequently used in the US.

Competent Authority Report

The IRS recently issued its competent authority statistics for the 15-month period from October 1 2012 through December 31 2013. In moving to a year-end reporting date, the statistics include three extra months. There are two categories of competent authority statistics: the first is the allocation of business and profits, which is undoubtedly mostly transfer pricing, and the second is all other treaty areas, which is generally not relevant to transfer pricing and not covered in this article.

In the allocation of business profits category, over 80% of the competent authority cases were resolved favourably for the taxpayer through either a total adjustment withdrawal by the initiating tax authority, full correlative relief, or part and part (partial correlative relief and partial withdrawal resulting in full relief). Partial relief was granted in 8% of cases and no relief was given in 7% of cases.

Of the 35 US-initiated adjustments that were resolved, zero resulted in no relief, one resulted in partial relief, and the remaining 34 were favourably resolved. A 97% full-relief favorable resolution rate for US-initiated adjustments indicates that the competent authority programme is working well.

Consistent with prior years, the average processing time remained at about two years. The number of competent authority case requests increased. The number of US-initiated adjustments remained constant, but the number of foreign- initiated adjustments almost doubled.

The number of foreign-initiated adjustment resolutions (119) far exceeded the number of US-initiated adjustment resolutions (40). Of the 40 US-initiated adjustments five were withdrawn by the taxpayer.

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