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Introduction

- **What is competent authority ("CA")?**
- **Why is it relevant to you and the administration of your company's tax affairs?**
- **How do you best avail yourself of CA assistance?**

U.S. Competent Authority (“USCA”) In General

Tax treaties generally permit taxpayers to request USCA assistance when they consider that actions of the U.S., the treaty country, or both, result or will result in taxation contrary to the provisions of the applicable treaty. The USCA assists taxpayers with respect to matters covered in the mutual agreement procedure and exchange of information provisions of tax treaties.

U.S. Competent Authority ("USCA") In General

- **U.S./India mutual agreement procedure (Art. 27)**
  - **A taxpayer may present a case to the competent authority of the home state within three years of the date of receipt of notice of the action which gives rise to taxation not in accordance with the Treaty**
  - **The competent authorities of both states shall endeavor to resolve the case by mutual agreement to avoid taxation not in accordance with the Treaty and may also consult together for the elimination of unintended double taxation**
  - **The competent authorities of both States may communicate with each other directly and implement unilateral and bilateral procedures to facilitate the implementation of the mutual agreement procedures**

U.S. Competent Authority (“USCA”) In General

- **U.S./India Exchange of Information provision (Art. 28)**
  - **The competent authorities of both States shall exchange such information to carry out the provisions of the Treaty**
  - **Any information received by a State shall be treated as secret under the laws of that State but if the information is originally regarded as secret in the transmitting State, it shall be disclosed only to persons involved in the administration of the taxes which are the subject of the Treaty**
  - **The provisions are not to be construed so as to impose on either State the obligation: (a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other State; (b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other State; (c) to supply information which would disclose certain secret or trade information**

U.S. Competent Authority ("USCA") In General

- **Typical cases*:***
  - **double taxation from transfer pricing or other adjustments**
  - **permanent establishment issues**
  - **residency issues**
  - **other adjustments which offend a bilateral treaty**
- **The provisions of the applicable treaty should be examined to ascertain whether USCA assistance is available in each particular case.**

U.S. Competent Authority ("USCA") In General

- U.S. initiated adjustments
- Foreign initiated adjustments
- Foreign-to-foreign cases

U.S. Competent Authority ("USCA") In General

CA assistance should be seen as one tool or forum among many to advocate your company's cause. Among the courts (Tax Court, district court, Claims Court), IRS examination, IRS, Appeals, alternative dispute resolution techniques (e.g., APAs, fast track mediation, TEAM/TAMs and other written determinations), and tax legislation/regulation/ruling advocacy.

U.S. Competent Authority ("USCA") In General

CA proceedings are government-to-government negotiations during which the taxpayer is not "in the room."

U.S. Competent Authority ("USCA") In General

Integral Players

- **USCA office (as assisted by IRS examination personnel)**
- **foreign CA (the powers, authority, training, and capabilities of foreign CAs vary widely)**
- **a U.S. Embassy (RSR, Tax Attaché, Ambassador)**

U.S. Competent Authority ("USCA") In General

The Deputy Commissioner (International) Large and Mid-Size Business acts as the USCA in administering the operating provisions of tax treaties. This duty includes interpreting and applying the provisions of tax treaties as well as entering into settlement agreements with other competent authorities.

U.S. Competent Authority ("USCA") In General

- **Requests for USCA assistance must be submitted in accordance with Rev. Proc. 2006-54, 2006-49 IRB 1.**
- **Requests for USCA assistance that involve an advance pricing agreement ("APA") request must be submitted in accordance with Rev. Proc. 2006-9, 2006-2 IRB 278.**

U.S. Competent Authority ("USCA") In General

A taxpayer's failure to request USCA assistance or to take the appropriate steps to maintain availability of a remedy may cause a denial of part or all of any foreign tax credits claimed.

When Requests For USCA May Be Filed:

In the case of a U.S. initiated adjustment of tax or income resulting from a tax examination, a request for USCA assistance may be submitted as soon as practicable after the amount of the proposed adjustment is communicated to the taxpayer in writing.

When Requests For USCA May Be Filed:

In the case of a foreign initiated adjustment of tax or income resulting from a tax examination, a request for USCA assistance may be submitted as soon as the taxpayer believes such filing is warranted based on the actions of the treaty country proposing the adjustment.

When Requests For USCA May Be Filed:

In a case involving the reallocation of income or deductions between related entities, a request for USCA should be filed when the taxpayer can establish that there is the possibility of double taxation.

How Requests Are Filed:

The request must conform to the requirements of Rev. Proc. 2006-54. The essential elements which must be included are:

- a reference to the specific treaty and the provisions therein pursuant to which the request is made
- if applicable, a description of the control and business relationships between the taxpayer and any relevant related person
- a brief description of the issues for which CA assistance is requested
- an explanation of the nature of the relief sought or the action requested in the U.S. or in the treaty country with respect to the issues raised
- a statement of relevant domestic and foreign judicial or administrative proceedings which involve the taxpayer and related persons
- on a separate document, a statement that the taxpayer consents to the disclosure to the CA of the treaty country and that CA's staff, of any or all of the items of information set forth or enclosed in the request for USCA assistance within the limits contained in the tax treaty under which the taxpayer is seeking relief
- a penalties of perjury statement in the form set forth in Rev. Proc. 2006-54

Protective Filing

- **If a taxpayer cannot file a formal competent authority request before the statute of limitations expires, the taxpayer should make a protective filing notifying the competent authority. Such a filing will be treated as a protective claim for credit or refund should (i) the treaty not waive procedural barriers or (ii) the competent authorities fail to provide relief. It is appropriate where: (i) a foreign-initiated adjustment is being considered but not yet proposed; (ii) a foreign-initiated adjustment has been proposed but the taxpayer will pursue administrative or judicial remedies in the foreign country; or (iii) the terms of the applicable treaty require notification to be made to the competent authority within a certain time period.**

Submissions

Short eloquent documents tailored to the specifics of the case which avoid the use of boiler-plate recitations of U.S. law/regulations are best.

Submissions

The taxpayer must also, on request, submit any other information or documentation necessary for the U.S. and foreign CA to reach agreement. This includes English translations of documentation required in connection with a request for USCA assistance.

USCA Procedure

The taxpayer must keep the USCA informed of all material changes in the information or documentation submitted as part of, or in connection with, the request for USCA assistance.

USCA Procedure

USCA will grant a pre-filing conference to discuss the mutual agreement process, matters covered under a treaty, the proper time for filing, and the practical aspects of obtaining relief.

USCA Procedure

The USCA's denial of a taxpayer's request for USCA assistance or dismissal of a matter previously accepted for consideration is final and not subject to administrative review. Yamaha Motor Corp. v. U.S., 779 F. Supp. 610 (D.D.C. 1991).

USCA Procedure

If a taxpayer's request for USCA assistance is accepted, the USCA will consult with the appropriate foreign CA to negotiate a mutual agreement that is acceptable to all parties.

Practice Points

The key is effective advocacy

There is no means of compelling a recalcitrant tax authority to agree. The CA process is based upon comity and cooperation between nations as expressed in a bilateral treaty.

Practice Points

- **There have long been discussions on whether arbitration can be used to compel competent authority agreements. Recent developments include:**
  - **OECD Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes (Feb. 2006) - In February 2006, the OECD circulated a draft proposal for mandatory arbitration of competent authority disputes;**
  - **In June 2006, the U.S. and Germany signed an income tax treaty protocol amending the 1989 U.S.-Germany Income Tax Treaty to allow arbitration where the competent authorities are unable to reach complete agreement in a case;**
  - **It has been reported that the U.S. and Canada will soon announce a protocol to allow arbitration under the U.S.-Canada Income Tax Treaty.**

Practice Points

Recognize the in-county political, economic, policy, or other constraints on the CA and attempt to address these issues. The CA must obtain approval for an agreement and will be asked about these issues.

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Practice Points

- The competent authorities meet infrequently and address numerous cases when they do meet. It is therefore important for the positions of the two sides to be as consistent as possible in advance of the meeting. The taxpayer must take an active role in ensuring that this happens. Additionally, because of the nature of the government-to-government communications, the competent authorities often provide the taxpayer with information though informal oral discussions. For this reason, face-to-fact meetings with the competent authorities are important.

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Practice Points

How best to motivate/induce the foreign CA to reach agreement:

- Stick to principled positions (*i.e.,* those based upon U.S., domestic law, OECD rules, or best practices in cohort countries).

Credibility is crucial:

- Maintain level playing field - inform both sides.
- Do not allow either CA to be "blind-sided."

Meet with both sides:

- Develop a personal rapport.
- In-country meetings are helpful.

Practice Points

Meetings typically alternate between the two countries. Be alert to scheduled meetings and meet with the foreign CA when they are in the U.S. Similarly, be in close touch with the USCA team before they depart and know how to reach them when they are in-country.

USCA – Case Resolution

- The USCA will notify the taxpayer requesting USCA assistance of any agreement that the U.S. and the foreign competent authorities reach.
  - If the taxpayer accepts the agreement, it becomes final and is not subject to administrative or judicial review. The taxpayer may be requested to sign a closing agreement.
  - If the competent authorities fail to reach an agreement, or if any agreement is not acceptable to the taxpayer, the taxpayer may withdraw its request and pursue all other rights under U.S. and foreign laws.

USCA – Case Resolution

The taxpayer may also request a conference to discuss the resolution of a case once it has been resolved by the U.S. and foreign competent authorities.

News and Recent Developments

IRS Statistics on 2005 Competent Authority

- In 2005, IRS received 75 new foreign-initiated allocation cases and 34 US-initiated allocation cases bringing its total inventory to 199 allocation cases.
- Case processing time – an average of 845 days for 2005, 941 days for 2004, and 860 days in 2003.
- Slight decrease in instances in which relief not granted –2.22% in 2005 and 4.66% for 2004.
- Average time for APAs in 2005 was 3.47 years, in 2004 was 3.43 years, and in 2003 was 2.74 years.

News and Recent Developments

IRS Statistics on Competent Authority Relief (2000-2005)*

RELIEF	2000	2001	2002	2003	2004	2005	5 Year Average FY 2001 - FY 2005
Correlative Adjustment	25.94%	31.53%	40.74%	36.55%	28.68%	50.59%	37.62 %
Adjustment Withdrawn	72.65%	59.67%	29.15%	55.32%	64.36%	37.62%	49.22%
Partial Relief	0.37%	3.12%	29.10%	5.73%	2.3%	9.56%	9.96%
No Relief**	1.04%	5.68%	1.01%	2.40%	4.66%	2.22%	3.19%

*Includes Allocation and Non-allocation cases only. Figures represent a percentage of the total dollar adjustment. Amounts do not include taxpayer withdrawals.

**In 2003, one extraordinarily large case has been omitted, as it would render analysis of the remainin meaningless.

News and Recent Developments

March 31, 2006 IRS report on APAs

- In 2005 82 APA applications were filed, 53 APAs were executed, and 240 requests were pending at the end of the year.
- Average time to complete bilateral APAs was 51.0 months in 2005.
- Comparable profits method was the dominant method used in APAs (with a PLI of operating margin).
- Compustat, Disclosure, and Worldscope were the primary sources of comparable company information.

Transfer Pricing

Overview

1. How the IRS applies the arm's length standard to intercompany transactions
2. Understanding the new intercompany service regulations
3. How to comply with Section 482 requirements

Introduction

This matter of allocation is thus not to be viewed as a typical skirmish between taxpayers and the IRS, involving only the typical parochial interests that normally color such skirmishes. On the contrary, its proper resolution is a challenge to the vision and statesmanship of those who speak of the present and coming stature of the "multinational corporation."

-- Stanley S. Surrey, Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482, 75 J. Tax'n (Feb. 1968).

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Common Control Requirement

Section 482 authorizes the IRS to make adjustments or reallocations when necessary in order to prevent evasion of taxes or clearly reflect income. While such adjustments or reallocations may only be made between or among organizations "owned or controlled directly or indirectly by the same interests," these terms are broadly defined. The transfer pricing regulations define control as "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose." Treas. Reg. § 1.482-1(i)(4).

The Arm's Length Standard

If common control exists, the IRS may reallocate income between members of the controlled group if a taxpayer has not reported its true taxable income. In determining the true taxable income of a controlled taxpayer, the standard to be applied is the arm's length standard, which is satisfied if "the results of the controlled transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances." Treas. Reg. § 1.482-1(b).

Transfer Pricing Methods

The transfer pricing regulations identify several transfer pricing methods ("TPMs") for determining whether the arm's length standard is satisfied. TPMs vary with the type of transaction. Typically, transactions can be characterized as one of the following: (i) transfers of tangible property; (ii) transfers of intangible property; (iii) performance of services; and (iv) loans or advances.

The Best Method Rule

The arm's length result of a controlled transaction must be determined under the TPM that, under the facts and circumstances, provides the most reliable measure of an arm's length result. For taxable years beginning after October 6, 1994, there is no strict priority for TPMs. Additionally, the regulations authorize the use of an unspecified method if that method provides the most reliable measure of an arm's length result.

TPMs For Transfers of Tangible Property

The transfer pricing regulations identify the following five TPMs which can be used to evaluate the arm's length nature of transfer prices in connection with the transfer of tangible property:

- **comparable uncontrolled price method**
- **resale price method**
- **cost plus method**
- **comparable profits method**
- **profit-split method**

Comparable Uncontrolled Price Method

Under the comparable uncontrolled price method ("CUP method"), the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales with allowable adjustments. Uncontrolled sales are sales in which the seller and buyer are not members of the same controlled group. Included within this definition are sales by a controlled group member to an unrelated party, sales to a controlled group member by an unrelated party, and sales between unrelated parties who are not members of the controlled group.

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Comparability Under The CUP Method

Moreover, comparability under the CUP method is dependent upon the similarity between the products as well as similarity between the contractual terms and economic conditions. If differences exist which would affect price, adjustments must be made to the price of the uncontrolled transaction. If adjustments cannot be made, the CUP method is generally inapplicable. Examples of factors which could affect price include contractual terms, geographic market, and date of sale.

The Resale Price Method

The resale price method ("RPM") uses a gross margin to determine whether a transfer price satisfies the arm's length standard of Section 482. The arm's length standard is satisfied if the taxpayer earns an appropriate markup (measured by the gross margin). The appropriate markup equals the gross margin earned in comparable uncontrolled transactions, preferably in which the taxpayer both purchases products from, and resells products to, unrelated parties (referred to as an internal uncontrolled transaction). The RPM may also utilize transactions in which a third party purchases products from, and resells products to, unrelated parties (referred to as an external uncontrolled transaction).

Comparability Under The RPM

Because the RPM is a transactional method, in that it compares the taxpayer's transactions to uncontrolled transactions, its reliability turns on the comparability of the uncontrolled transactions. The regulations make clear that close physical similarity of the products in the comparable sales is not required. Rather, the regulations emphasize that the functions performed by the reseller must be comparable to the functions performed by the taxpayer. Thus, the regulations favor internal uncontrolled transactions over external uncontrolled transactions.

Cost Plus Method

The cost plus method uses the gross profit markup realized in uncontrolled sales as a benchmark for evaluating the transfer prices. Specifically, the cost plus method measures the markup as a percentage of costs in uncontrolled transactions and compares the results to the gross profit markup realized in a controlled transaction. The cost factor is the controlled taxpayer's cost of producing the property and, as such, this method is ordinarily used in cases involving the manufacture, assembly, or other production of goods.

Comparability Under The Cost Plus Method

Comparability under the cost plus method is particularly dependent on the similarity of functions performed, risks borne, and contractual terms. If possible, the appropriate markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the uncontrolled sale because similar characteristics are more likely to be found among sales of property by the same taxpayer.

Comparable Profits Method

Under the comparable profits method ("CPM"), a taxpayer's transfer prices are tested by comparing the taxpayer's profitability (as measured by a profit level indicator ("PLI")) with the profitability of unrelated companies that perform similar functions in comparable industries. This method generally relies upon the published financial information of unrelated companies, with adjustments to account for differences between the tested party and the uncontrolled taxpayers which would materially affect profitability.

Common PLIs Under The CPM

- Rate of return on capital employed - ratio of operating profit to operating assets
- Operating margin - ratio of operating profit to sales
- Berry ratio - ratio of gross profit to operating expenses

Interquartile Range

Typically, where the CPM is employed, a range of uncontrolled companies is used to establish the transfer price. The transfer pricing regulations provide for the application of statistical methods to increase reliability. The most commonly used statistical method is the interquartile range, which establishes the arm's-length range as between the 25th and 75th percentile of the results of the uncontrolled companies.

Comparability Under The CPM

Because the PLIs under the CPM are based upon broad operating profit comparisons, the regulations specify that comparability under the CPM is particularly dependent on resources employed and risks assumed. Because resources and risks are associated with functional differences, the regulations place an emphasis on the functions performed by the taxpayer and the uncontrolled companies and not on the physical similarity of the products sold.

Profit Split Method

The profit split method determines an arm's length charge by comparing the contributions each related party makes to the success of the venture and then allocating the profits from the venture between the parties. This method is only appropriate where each controlled taxpayer makes substantial contributions to the business and is inappropriate where a controlled taxpayer performs a limited function (*e.g.*, it would be inappropriate to use this method where a controlled taxpayer, which did not own nonroutine marketing intangibles, performed only a distribution function).

Services Which Only Incidentally Benefit A Related Party

The transfer pricing regulations provide that no compensation (or reimbursement) is required for services which only incidentally benefit a related party. The test is whether the probable benefits to the other members were so indirect or remote that they would not be willing to pay an unrelated party for such services. An example is stewardship services, whereby the parent company performs a review of the subsidiary's operations to protect and monitor its investment.

New Services Regulations

- On August 4, 2006, the IRS promulgated new services regulations. Treas. Reg. § 1.482-9T
- Effective date
  - Taxable years beginning after December 31, 2006
  - Taxpayers may elect to apply the regulations to earlier taxable years in certain circumstances

New Services Regulations

- The regulations enumerate transfer pricing methods that are appropriate for testing the arm's length nature of related-party service transactions. For the most part, the methods are variations of those used for transactions involving tangible property. For example, instead of a comparable uncontrolled price method (CUP), the services regulations include a comparable uncontrolled services price method ("CUSP"). Other enumerated methods are: the gross services margin method; the cost of services plus method; the comparable profits method; and the profit split method.

New Services Regulations

- One significant difference is the replacement of the cost safe harbor for services that are not integral with the services cost method ("SCM")

New Services Regulations

- **Old reimbursement at cost safe harbor**
  - **reimbursement at cost would be deemed to constitute arm's length compensation**
  - **to qualify for the safe harbor, the services could not be integrally related to either party's (*i.e.*,, the service provider or service recipient) business operations**
  - **objective criteria were used to make this determination**

New Services Regulations

- In 2003, the Treasury and IRS proposed to eliminate the reimbursement at cost safe harbor and impose the simplified cost-based method ("SCBM") under which controlled services that satisfied certain requirements could be priced by reference to the markup on total services costs of uncontrolled taxpayers that engage in similar business activities under similar circumstances. The SCBM was, in essence, a comparable price method (CPM) analysis with the service provider as the tested party.

New Services Regulations

- **SCBM discussion**
  - **The key feature of the SCBM was that the IRS could make an allocation only if the arm's length markup exceeded the markup charged by the taxpayer by at least a certain amount (expressed as percentage points). The applicable number of percentage points was 6 if the amount charged by the taxpayer equaled total services costs, and the applicable number of percentage points declined ratably to zero by 1 percentage point for every increase of 2 percentage points in the markup on total services costs charged in the controlled transaction.**

New Services Regulations

- SCBM example
  - To make an allocation where the taxpayer received no markup, the IRS had to show that the arm's length markup was at least 6 percent. If the taxpayer had a markup of 2 percent, the IRS could only make an allocation if the arm's length markup was at least 7 percent.

New Services Regulations

- **The new services cost method (SCM) (Treas. Reg. § 1.482-9T)**
  - **Eliminates the controversial simplified cost based method and allows reimbursement at cost for (i) specifically enumerated services and (ii) low margin services (services for which a markup of seven percent or less would be charged in an arm's-length transaction).**
  - **In a contemporaneously issued announcement (Announcement 2006-50), the IRS included the following among the list of specifically enumerated qualified services: payroll; accounting, tax, and legal; public relations; computer support; implementing and processing employee benefits; and general clerical functions.**

New Services Regulations

The services cost method (cont.)

- **Cannot be applied to the following services:**
  - Services that contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the renderer, the recipient, or both
  - Manufacturing
  - Production
  - Extraction, exploration or processing of natural resources
  - Construction
  - Reselling, distribution, acting as a sales or purchasing agent
  - Research, development, or experimentation
  - Engineering or scientific
  - Financial transactions, including guarantees
  - Insurance or reinsurance

New Services Regulations

- The new regulations also provide for a shared services arrangement ("SSA"), which is an agreement governing how the costs for covered services will be allocated among two or more affiliates benefiting from such services.
- Where taxpayers use an SSA, additional documentation must be maintained setting forth the taxpayers' intent to use an SSA, the allocation basis used under the SSA, and the services to be performed.

TPMs For Transfers Of Intangible Property

The transfer pricing regulations identify the following three TPMs which can be used to evaluate the arm's length nature of transfer prices in connection with the transfer of intangible property:

- **comparable uncontrolled transaction method**
- **comparable profits method**
- **profit-split method**

TPMs For Transfers of Intangible Property

The comparable uncontrolled transaction method ("CUT") is analogous to the CUP method, but the uncontrolled transaction must involve the same <u>intangible</u> property or comparable <u>intangible</u> property.

Similarly, the application of the CPM and profit-split methods are the same under regulations governing transfers of intangible property as they are under the regulations governing transfers of tangible property.

TPMs For Transfers of Intangible Property

When an intangible is embedded within tangible property, there is typically no separate allocation for the intangible. For example, if a U.S. distributor is entitled to use the related foreign manufacturer’s trademark in marketing the foreign manufacturer's products in the U.S., there generally would be no separate allocation for the intangible. Rather, it is deemed embedded in the price that the distributor pays to the manufacturer for the products.

TPMs For Transfers of Intangible Property

In the previous example, if the U.S. distributor's advertising and marketing activities are deemed to be beyond the activities that an unrelated distributor would perform, and, such activities increase the value of the intangible property (*e.g.*, increase the manufacturer's brand name), then the U.S. distributor may be required to receive compensation for the incremental services that it provides.

Compliance With Section 482

U.S. taxpayers engaging in intercompany transactions must report arm's length results in a timely-filed U.S. income tax return. Consequently, each year, a U.S. taxpayer must do the following:

- analyze the arm's length nature of its transfer prices
- make any necessary compensating adjustments
- make any necessary conforming adjustments
- report arm's length results in its income tax return

Analyze The Arm's Length Nature Of Its Transfer Prices

At the end of each taxable year, the taxpayer must test the arm's nature of its transfer prices using an appropriate transfer pricing method.

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Make Any Necessary Compensating Adjustments

If the taxpayer's financial results do not satisfy the arm's length standard, then the taxpayer must make a compensating adjustment to its transfer prices for tax purposes. In essence, the compensating adjustment is a retroactive adjustment to a transfer price that is made after the close of the taxable year (but before the tax return is filed). The adjustment, for tax purposes, is deemed to accrue on the last day of the taxable year for which it is made.

Conforming Adjustments

To conform its accounts, the U.S. taxpayer must file an election with its federal income tax return explaining the circumstances that resulted in the transfer pricing adjustment. The taxpayer is permitted to establish (i) an account payable to the related party or (ii) an account receivable from the related party, which shall be deemed to have been created as of the last day of the taxable year to which the transfer pricing adjustment relates and shall bear interest at an arm's length rate. The account must be satisfied within 90 days by: (i) monetary payment; (ii) written debt obligation payable at a fixed date and bearing an arm's length rate of interest; or (iii) offsetting the account against an existing bona fide debt between the related parties.

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Conforming Adjustments

If a taxpayer does not conform its accounts to reflect a transfer pricing adjustment, the IRS will do so by imposing a secondary adjustment. Generally, the secondary adjustment conforms the taxpayer's accounts by recharacterizing the amount of the initial transfer pricing adjustment as a dividend or a capital contribution. For example, if the taxpayer paid above arm's length prices to its parent for raw materials, the payment of the excess purchase price will be recharacterized as the payment of a dividend. If the purchase price was too low, then the deficit will be recharacterized as a capital contribution from the parent.

Report Arm's Length Results in Its Income Tax Return

The arm's length results must be reported in the taxpayer's federal income tax return. Although an amended return can be filed to increase taxable income, the regulations prohibit taxpayers from using section 482 to decrease their taxable income in an amended return.

Protecting Against Transfer Pricing Adjustments And Transfer Pricing Penalties

- **Steps that taxpayers should take to protect against transfer pricing adjustments and transfer pricing penalties include documenting intercompany transactions with written agreements and preparing and maintaining contemporaneous documentation.**
- **An advance pricing agreement is a proactive compliance measure that can fully protect a taxpayer against adjustments and penalties.**

Written Agreements

Written agreements are important in identifying the terms of intercompany transactions and the allocation of risks between the parties. The IRS will respect the terms of an agreement if they are consistent with the economic substance of the underlying transactions.

Contemporaneous Documentation

Section 6662(e) imposes a 20 percent penalty on a net transfer pricing adjustment that exceeds the lesser of $5 million or 10 percent of the taxpayer's gross receipts. A taxpayer may avoid the Section 482 penalty if (i) the taxpayer has documentation (which was in existence as of the time of filing the return) which sets forth the determination of such price in accordance with an appropriate transfer pricing method and which establishes that the use of such method was reasonable, and (ii) the taxpayer provides such documentation to the IRS within 30 days of a request for such documentation.

Glaxo Case

- **A significant transfer pricing case in the Tax Court, *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, U.S. Tax Court Docket Nos. 005750-04 and 006959-05, was recently settled with the taxpayer agreeing to pay $3.4 billion and abandon its refund claim of $1.8 billion.**

Glaxo Case

- The IRS alleged that Glaxo's U.S. company was not a mere distributor, but, rather, acted as a fully integrated pharmaceutical company performing R&D, manufacturing, and marketing functions. As such, Glaxo's profits should be more substantial.
- One argument raised by Glaxo was that it was denied an advance pricing agreement ("APA"), while its competitors received APAs on similar transactions. This renewed the discussions concerning the confidentiality of APAs and competent authority negotiations.

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