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Transfer Pricing 2023

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Sanford W Stark, Saul Mezei,
Terrell Ussing and Anne Devereaux
Gibson Dunn & Crutcher LLP

USA

Law and Practice

Contributed by:
Sanford W Stark, Saul Mezei, Terrell Ussing and Anne Devereaux
Gibson Dunn & Crutcher LLP

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Authors

Sanford W Stark is co-chair of the global tax controversy and litigation group at Gibson Dunn & Crutcher and the leader of the group's premier transfer pricing practice. He represents a number of the world's largest multinational companies in high-profile, high-stakes matters. Sanford's practice focuses on all stages of federal tax controversy and litigation, and includes substantial experience and expertise in transfer pricing. He teaches "Survey of Transfer Pricing" in the Georgetown University Law Center's graduate tax programme and is an elected member of the American College of Tax Counsel. Sanford is a frequent speaker on tax controversy and transfer pricing topics, and is a co-author of "Transfer Pricing: Litigation Strategy and Tactics", BNA Tax Management Portfolio.

Saul Mezei represents clients of Gibson Dunn & Crutcher at all stages of federal tax controversy, from audit and administrative appeals to trial and judicial appeals. He focuses on international transfer pricing, with an emphasis on the identification and valuation of intangibles. Saul is an adjunct professor at the Georgetown University Law Center, currently teaching "Survey of Transfer Pricing". He is the co-author of "Transfer Pricing: Litigation Strategy and Tactics", BNA Tax Management Portfolio, and a regular contributor to various tax publications.

Terrell Ussing focuses his practice at Gibson Dunn & Crutcher on federal tax controversy and litigation. Terrell counsels multinational companies across all industries in all aspects and phases of tax controversy and litigation. He has significant experience representing clients on a range of complex domestic and international tax issues, with an emphasis on transfer pricing, including complex transfer-pricing litigation, planning and risk assessment at the federal, international and state levels. Terrell is an adjunct professor in the graduate tax programme of Georgetown University Law Center where he teaches "Survey of Transfer Pricing". He is a frequent speaker on transfer pricing, tax controversy and litigation topics.

Anne Devereaux is of counsel in the Washington, DC and Los Angeles offices of Gibson, Dunn & Crutcher. Since joining the firm in 2022, Anne has frequently worked on controversy matters including novel issues regarding transfer pricing, foreign tax credit, sourcing of income, and financial products. Before joining the firm, Anne held several senior positions in the IRS Office of the Associate Chief Counsel, International. She also served for several years as an adjunct professor at the Georgetown University Law Center, co-teaching a course on foreign tax credits. Prior to working at the IRS, Anne clerked for the Honourable Herbert Chabot at the United States Tax Court.

Gibson Dunn & Crutcher LLP

1050 Connecticut Avenue
NW Washington
DC 20036-5306
USA

Tel: +1 202 955 8500
Fax: +1 202 467 0539
Email: SStark@gibsondunn.com
Web: www.gibsondunn.com

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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 in length 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 transfer pricing 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 that have interpreted 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, though, 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 significant being revisions that followed the "1988 White Paper" that had been 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 the most extensive revisions to the transfer pricing regulations since their inception.

Among the most significant changes that arose out of those 1994 changes was to make clear that in performing transfer pricing valuation, 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" which ensures that controlled parties are pricing their transactions in accordance with the arm's length standard, no method is preferred over any other.

Cost Sharing Agreements

Moreover, 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 in the past ten to 15 years. 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 among the most detailed and complex provisions of the Treasury regulations related to transfer pricing.

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 owns 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 laws list a number of specific transfer pricing methods that taxpayers can use depending on whether the controlled transactions relate to 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 the transfer of tangible or intangible property are both 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, all transactions among related parties may utilise an "unspecified" method if it is the "best method" to determine 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. However, US courts have sometimes shown a preference for transactional-based methods, such as the CUT or CUP methods, in appropriate circumstances.

3.4 Ranges and Statistical Measures

The US has no direct "statistical measure" requirement, other than to the extent that statistics are used as tools within the various specified or unspecified methods.

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 the 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. These 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 commensurate with income (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 defined in Code Section 367(d), which was more expansive and included "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 to a residual "unspecified method" (in Section 1.482-4(d)), which must satisfy certain criteria.

Section 1.482-4 also provides, in addition to two of the possible methods for determining the arm's length pricing in an intangibles transfer, 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 for cost sharing arrangements.

4.2 Hard-to-Value Intangibles

The OECD

Treasury regulations addressing controlled transactions involving intangible property pre-date 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 the ex post evidence about financial outcomes to inform the determination of the 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) gives five exceptions from application of the periodic adjustment rule. These exceptions to some extent mirror the four exemptions from application of the HTVI rule, 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 accounted for reasonably foreseeable events and other risks, then adjustments using ex post profit 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 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, 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; 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 likewise may restrict or prevent the tax authorities 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, with the first APA completed in 1991. The APA programme 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. 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 approximately 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 2022, covering January through to December 2021, at the end of 2021 "the APMA Program comprised 80 team leaders, 25 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 the jurisdiction of APMA, such that the same APMA teams and personnel have responsibility 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.

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 having 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 31 December 2018, the fees are USD113,500 for new APAs, USD62,000 for renewal APAs, USD54,000 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 USD23,000 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 2021 was six years, but the full range of terms spanned from one to 15 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 price 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) with respect to such portion.

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) has protection against the imposition of either transfer pricing penalty.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Treasury Regulation Section 1.6038-4 – entitled "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 entity of a US multinational enterprise (US MNE) group 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 ("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).

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.

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 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 co-ordination between transfer pricing and customs valuation. Code Section 1059A and the Treasury regulations thereunder look to ensure that, when any property is imported into the United States in a related-party transaction, the importer cannot claim a higher tax basis on its imported merchandise than the value that 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 different from 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 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 (italicised) 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, however, that continues to confound not only taxpayers but also the tax and customs authorities, which are not as co-ordinated as they would like. These tax versus customs obligations must, therefore, be considered carefully.

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 sometimes including 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 bypass the administrative appeal process and head straight to litigation if it desires.
- 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 response to it, and will conduct one or more hearings 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 on audit or before the IRS Independent Office of Appeals can proceed to court.
- Judicial process (trial and appeal) – a taxpayer generally can 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 the United States 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 appealed to the US Supreme Court, which has discretion as to whether to entertain the appeal (and which, in fact, entertains very few appeals).

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. Some of these 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.
- 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 (1) 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; (2) the IRS may only cancel an APA for a limited set of grounds listed in the relevant revenue procedure, which the IRS failed to prove; (3) the taxpayer's post-return self-corrections to comply with the APA are Code Section 482 adjustments; and (4) 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 (US Tax Court) – still active): The Tax Court ruled that the IRS was not arbitrary and capricious in applying the comparable profits method with 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.
- 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.
- 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 rejected 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 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 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.
- B Forman Co v Commissioner (1970 (US Tax Court); 1972 (2nd Circuit): The Tax Court 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.

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.

15.3 Effects of Other Countries' Legal Restrictions

The US regulation regarding the effects of other countries' legal restrictions has been 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 recently validated the regulation in 3M Co & Subs v Commissioner. The same issue is also presented in The Coca-Cola Co v Commissioner.

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 numbers and percentages 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 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 reports on IRS transfer pricing audit outcomes.

16.2 Use of "Secret Comparables"

The United States is not known to rely on secret comparables for transfer pricing enforcement. Typically, at the end of a transfer pricing audit, if the IRS is going to assert a transfer pricing adjustment, 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 would 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.

17. COVID-19

17.1 Impact of COVID-19 on Transfer Pricing

It is generally too soon to tell how COVID-19 may affect the transfer pricing landscape in the United States. It is certainly possible that COVID-19-related economic impacts may affect the value of intangibles, tangible goods, services transactions and any other market transactions that provide comparables for transfer pricing analyses. The impacts of COVID-19 should become more apparent in the years ahead.

17.2 Government Response

To date, the IRS has not relieved payment obligations or otherwise relaxed standards in response to COVID-19 and its after-effects.

17.3 Progress of Audits

IRS transfer pricing audits continued during COVID-19. While some transfer pricing audits have slowed somewhat, in general, existing transfer pricing audits have proceeded apace, certain transfer pricing audits have concluded, and new transfer pricing audits have commenced.

Trends and Developments

Contributed by:
Sanford W Stark, Saul Mezei, Terrell Ussing and Anne Devereaux
Gibson, Dunn & Crutcher LLP

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Authors

Sanford W Stark is co-chair of the global tax controversy and litigation group at Gibson Dunn & Crutcher and the leader of the group's premier transfer pricing practice. He represents a number of the world's largest multinational companies in high-profile, high-stakes matters. Sanford's practice focuses on all stages of federal tax controversy and litigation, and includes substantial experience and expertise in transfer pricing. He teaches "Survey of Transfer Pricing" in the Georgetown University Law Center's graduate tax programme and is an elected member of the American College of Tax Counsel. Sanford is a frequent speaker on tax controversy and transfer pricing topics, and is a co-author of "Transfer Pricing: Litigation Strategy and Tactics", BNA Tax Management Portfolio.

Saul Mezei represents clients of Gibson Dunn & Crutcher at all stages of federal tax controversy, from audit and administrative appeals to trial and judicial appeals. He focuses on international transfer pricing, with an emphasis on the identification and valuation of intangibles. Saul is an adjunct professor at the Georgetown University Law Center, currently teaching "Survey of Transfer Pricing". He is the co-author of "Transfer Pricing: Litigation Strategy and Tactics", BNA Tax Management Portfolio, and a regular contributor to various tax publications.

Terrell Ussing focuses his practice at Gibson Dunn & Crutcher on federal tax controversy and litigation. Terrell counsels multinational companies across all industries in all aspects and phases of tax controversy and litigation. He has significant experience representing clients on a range of complex domestic and international tax issues, with an emphasis on transfer pricing, including complex transfer-pricing litigation, planning and risk assessment at the federal, international and state levels. Terrell is an adjunct professor in the graduate tax programme of Georgetown University Law Center where he teaches “Survey of Transfer Pricing”. He is a frequent speaker on transfer pricing, tax controversy and litigation topics.

Anne Devereaux is of counsel in the Washington, DC and Los Angeles offices of Gibson, Dunn & Crutcher. Since joining the firm in 2022, Anne has frequently worked on controversy matters including novel issues regarding transfer pricing, foreign tax credit, sourcing of income, and financial products. Before joining the firm, Anne held several senior positions in the IRS Office of the Associate Chief Counsel, International. She also served for several years as an adjunct professor at the Georgetown University Law Center, co-teaching a course on foreign tax credits. Prior to working at the IRS, Anne clerked for the Honourable Herbert Chabot at the United States Tax Court.

Gibson Dunn & Crutcher LLP

1050 Connecticut Avenue
NW Washington
DC 20036-5306
USA

Tel: +1 202 955 8500
Fax: +1 202 467 0539
Email: SStark@gibsondunn.com
Web: www.gibsondunn.com

GIBSON DUNN

Contributed by: Sanford W Stark, Saul Mezei, Terrell Ussing and Anne Devereaux, **Gibson, Dunn & Crutcher LLP**

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 consistent. What has evolved over the past decade, however, is the US Internal Revenue Service's (IRS's) efforts at heightened transfer pricing enforcement under those regulations, and, collaterally, heightened transfer pricing enforcement at the state level as well. 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 attempting to develop standard practices and processes for use in all transfer pricing audits. Those efforts prompted the IRS Large Business & International Division (LB&I) within the IRS Examination function to issue a Transfer Pricing Audit Roadmap (the "Roadmap") in 2014. LB&I replaced the Roadmap in 2018 with a document entitled 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. Effective from 9 January 2023, the IRS updated Internal Revenue Manual Section 4.61.3 (Development of IRC 482 Cases) 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 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 the planning and analysis of taxpayers' transfer pricing without meaningful taxpayer input has worried taxpayers and practitioners.

The execution phase resembles what a transfer pricing audit used to look like. The IRS issues information requests and develops the facts. The IRS is supposed to meet periodically with the taxpayer to confirm relevant facts and is supposed to 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 (ie, to lock down the facts before proposing a transfer pricing adjustment). Following receipt of a taxpayer's AOF response, the IRS may issue additional information requests if necessary.

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”.

The TPEP publication does not mandate an audit timeline. But it contains two exhibits with examples of transfer pricing examinations – one over 24 months and the other over 36 months. The TPEP publication specifies that the sample timelines should only be used as examples and that every examination plan’s timeline should be tailored to the specific facts.

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 February 2019, LB&I issued directive LB&I-04-0219-001, which mandates that LB&I examination teams must 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.

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, in 2015) and APMA. TTPO is a division of LB&I, and APMA is a division of 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 comprise 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 taxpayers 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 result, 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 (increase) to 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 over the issue if the US competent authority accepts a request; ie, 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 arm's length under the transfer pricing rules of the foreign country. The US competent authority having jurisdiction means it 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 directive was included in Section 4.61.3.6 of the Internal Revenue Manual. The directive 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 directive also clarifies that examiners are ultimately responsible for the selection and development of issues, and cautions the need that "an appropriate degree of independence is maintained from the competent authority process". For examinations opened after 30 September 2017, approval from the Transfer Pricing Review Panel (the "TPRP") is required where the LB&I examiner believes the taxpayer's best method (as reflected in the taxpayer's Section 6662 transfer-pricing documentation) is wrong. The TPRP generally consists of the TPP director of field operations 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.

An interesting dynamic will likely develop in the IRS process for making transfer pricing adjustments in situations involving treaty-partner countries. According to the directive, APMA involvement is only intended to influence LB&I examiner behaviour, and not the other way around. For example, will the sharing of information and experience by APMA with LB&I examiners mean the examiners are less likely to make transfer pricing adjustments that would be modified or entirely rejected by the US competent authority? The TPRP may be a step in that direction, and taxpayers would welcome additional developments.

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

In August 2020, LB&I signalled its intent, in effect, to withdraw Revenue Procedure 94-69. The Revenue Procedure allows 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 so-called accuracy-related 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 originally filed return but also any additional amount shown as additional tax on a "qualified amended return" (QAR). So, disclosing additional tax on a QAR lowers the risk that a Section 6662 penalty may 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 relevant taxable year.

This timing requirement was troublesome for large domestic corporate taxpayers that were subject to audit under the "Coordinated Industry Case" (CIC) program (the successor of the 1966 "Coordinated Examination Program"). CIC program taxpayers included all domestic corporations over a certain size. CIC program taxpayers were under continuous audit, with all their tax returns audited year after year; such taxpayers 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". So, to alleviate the inequity faced by CIC taxpayers, the IRS issued Revenue Procedure 94-69, which allows such taxpayers to file a written statement with their examination team within a certain period near the start of an exam, and this written statement is treated as a QAR. CIC taxpayers could thus reduce their risk of having penalties assessed by disclosing, to the IRS exam team, additional amounts of tax due.

In May 2019, the IRS announced a replacement of the CIC program with the "Large Corporate Compliance" (LCC) program. The LCC program nominally replaces the CIC program's automatic examination of every return with a method for selecting returns to examine using data analytics "to identify the returns that pose the highest compliance risk". The LB&I August 2020 notice of intent to withdraw Revenue Procedure 94-69 said, in essence, that because LCC is not a continuous examination programme, there is no need for the Revenue Procedure, and asserted that the Revenue Procedure creates an advantage for LCC taxpayers over other taxpayers that must avail themselves of the "normal" QAR process.

Many former CIC taxpayers asserted that 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 may identify as carrying higher compliance risks. In response, the IRS partially walked back its position by issuing Revenue Procedure 2022-39.

Under the new Revenue Procedure 2022-39 disclosure regime, 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 program (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 February 2019 LB&I directive 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 ever-more significant presence in the US transfer pricing enforcement landscape. Data bears this out. From 2012 through to 2021, APMA concluded more than 100 APAs nearly every year, although the separate APA programme had never reached that total previously and had rarely topped 80. Likewise, APMA's MAP inventory has grown substantially since APMA's first year (2012), with 940 cases in its inventory at the end of 2020. Approximately two thirds of the cases in APMA's MAP inventory were 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 pending and any future initiatives in the OECD's base erosion and profit shifting project, 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 growing audit adjustments.

Faced with an ever-growing case inventory, LB&I has indicated that the IRS is considering additional early screening to determine the suitability of potential APA applications for acceptance into the APA programme.

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 related parties to determine how much income is properly "apportioned" to their state for the purposes of imposing state income and other such 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 Section 482 of the Internal Revenue Code and its implementing Treasury regulations 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 accordance with comparable transactions between unrelated parties. In the US, this issue 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 all together.

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 begun 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.

Taxpayers doing business in the US should, therefore, expect state revenue agencies to be particularly assertive in scrutinising those taxpayers' transactions. With the budget challenges brought about by COVID-19 particularly, states have begun utilising whatever tools they might have available to maximise revenue and increase their collection coffers. To prepare, companies doing business in the US should not only ensure that they prepare and update their interstate transfer pricing studies, but also should be prepared to face state challenges that rely on transfer pricing principles historically reserved for their multinational disputes.

Increasing LB&I Audit Activity

LB&I recently announced plans to expand audit efforts involving transfer pricing issues. LB&I intends to use data analytics to identify audit candidates. Whether LB&I can execute this plan depends on its ability to hire and train additional personnel.

Increased Scrutiny of Economic Substance

The IRS has signalled an intention to invoke economic substance 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 (WD Mich 2021). In Perrigo, 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.

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 predating 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 subject to a potential 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.

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 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 case presents a number of important issues and remains subject to appeal.

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