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US International Transfer Pricing

1.01 ROLE OF TRANSFER PRICING IN AN INTERNATIONAL TAX SYSTEM

One of the most important current business and tax considerations for any multinational corporation (MNC), regardless of whether its parent company is based in the United States, Japan, Germany, or elsewhere, is the way in which it prices goods, services, and intangibles, such as the results of research and capital transferred to its foreign affiliates. The transfer pricing policies and practices used in connection with the transfer of such assets from one affiliated corporation to another across borders have more impact on which governmental jurisdiction taxes the income generated from international transactions than any other aspect of the tax law. The importance of transfer pricing and its impact on the tax collections of the United States and other countries has brought this subject to the forefront of international tax debates.

In effect, the governments of countries involved in expanding international trade are competing with each other to assign taxable profits of MNCs into their jurisdictions--the quintessential tax base issue. MNCs need to exercise due diligence in order to avoid double taxation and tax penalties, which might be imposed after past years' tax returns are examined, if two governments assert claims to tax the profits earned by MNCs operating within their jurisdictions. The international tax mechanisms available to prevent double taxation generally require consultation at the government level, which is a slow and costly process and is not guaranteed to succeed in preventing double taxation. Modern business does its accounting on an annual basis and significant adjustments of prior years' taxes can have a most disruptive effect on the MNC. It is therefore important for MNCs to focus attention on their transfer pricing practices to avoid unpleasant surprises in the future. Some MNCs may also find that a focus on transfer pricing policies results in a lowering of taxes worldwide, as a result of planning opportunities previously overlooked.

While MNCs are concerned about potential double taxation, governments are concerned about the ability of MNCs to shift profits into low-tax jurisdictions, or any jurisdiction other than their own. The U.S. government has been particularly concerned about the transfer of intangible assets from U.S.-based MNCs to their foreign subsidiaries. The concern over MNCs' transferring the fruits of their U.S.-based research (for which U.S. tax deductions have probably been taken) is that foreign subsidiaries are able to earn higher profits outside the U.S. tax net. The foreign subsidiaries may be in low-tax countries that offer special tax incentives to MNCs, or they may be in countries that have a high tax rate. For the U.S. coffers, the result is more or less the same, because of the foreign tax credit system, which generally allows a credit for foreign income taxes against U.S. taxes due. By repatriating a mix of earnings from high- and low-tax foreign operations, the foreign tax credit system allows low-taxed manufacturing profits to be averaged with higher taxed profits. The foreign tax credit is the foundation of the U.S. international tax system and has helped U.S. MNCs to remain competitive overseas with their foreign rivals, whose countries, in many cases, exempt foreign income from tax altogether. After World War II, U.S. MNCs expanded their operations around the world and have tended to retain a portion of their earnings overseas. Accordingly, the Internal Revenue Service (Service) and the U.S. Congress have viewed transfer pricing as an issue mainly for U.S.-based MNCs and have sought to encourage the repatriation of income and discourage the outbound transfer of technology, and related matters, without arm's length compensation.

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While U.S. tax legislation and regulations on transfer pricing in the past have focused their attention on U.S.-based MNCs, the U.S. government has more recently become concerned about foreign MNCs that have subsidiary operations in the United States. For whatever reasons, foreign-based MNCs have been reporting lower taxable income than their U.S.-based counterparts. This has been attributed by the Service and members of Congress to their transfer pricing practices, although the reality is likely to be much more complex than that. For example, higher transfer prices for goods also mean higher import duties and higher income taxes in the seller's jurisdiction.

Governments also tend to ignore the many other considerations that influence intercompany prices. For example, in most subsidiaries, the country manager's performance evaluation and resulting bonus are based on pretax profits. In general, this encourages the subsidiary to maximize profits, regardless of the tax consequences. This has been the experience of many U.S.-based MNCs with their foreign subsidiaries. On the other hand, in some foreign-based groups, there may be a preference for paying taxes at the parent company level rather than to the subsidiary's tax jurisdiction; this may be because the funds are needed at home, or for patriotic or cosmetic reasons or, perhaps, to reduce foreign exchange risks.

Consequently, the U.S. government has felt that its tax base is eroding as a result of both U.S.-based MNCs' practice of retaining earnings overseas and foreign-based MNCs' preference for paying taxes outside rather than in the United States. The United States has targeted transfer pricing as an issue of major importance, for both inbound and outbound investments. It has made changes in the tax law to force MNCs to report increased earnings in the United States. It has issued complex and innovative regulations and enacted draconian penalties for noncompliance. It has paved the way for advance pricing agreements and has litigated countless situations and is continuing to litigate cases involving billions of dollars in back taxes.

In short, the U.S. government has forced MNCs to pay attention to transfer pricing from a tax standpoint and more and more has made the tax director of an MNC responsible for compliance with regulations and avoidance of penalties. It is more than likely that, through international governmental groups (such as the Organisation for Economic Co-operation and Development (OECD)), the governments of our trading partners will adopt similar approaches to transfer pricing.

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1.02 THE ARM'S LENGTH STANDARD AND EVOLUTION OF TRANSFER PRICING ISSUES

The question to be resolved is: How should a cross-border transfer price be set among related parties, be it for goods, services, or intangibles such as the fruits of research, trademarks and trade names, loans, or rents? The answer in most of the developed world is the "arm's length standard." The arm's length standard requires that intercompany prices be set as if the related parties were independent unrelated parties. For many decades, governments and taxpayers have struggled to define the arm's length standard in actual operations.

In the United States, the arm's length standard is entrenched in Section 482 of the Internal Revenue Code. Section 482 authorizes the Service to "distribute, apportion, or allocate" the income of related parties that are under common control, to the extent necessary to clearly reflect the income of each party or to prevent tax evasion. The first significant regulations that sought to expand on this one-sentence provision were issued in 1968, at a time when the United States was revamping its taxation of international operations. These regulations were expanded in 1994 and lay the foundations for two concepts:

1. That transfer pricing should be based on an arm's length standard, which allocates income on the basis of independent parties dealing with each other at arm's length, or the "separate entity" approach; and

2. That the arm's length standard should be determined on a transaction-by-transaction basis. Safe havens were provided in certain circumstances (e.g., for services, loans, and rentals of real property).

It is significant that Section 482 could equally have supported an apportionment approach, under which a formula might have been used to apportion total worldwide or regional income of an MNC group to each related party. Apportionment on a formulary basis is used by states in the United States to assign federally taxable income among themselves. Some states, of which California is the most notorious, even extended their apportionment to the worldwide income of an MNC, until a recent change to "water's edge" apportionment. Although there are still proponents of formulary or "unitary" apportionment in the U.S. government and in some of the states, this approach has been rejected by the U.S. government for federal tax purposes, and by the governments of industrial countries around the world. Nevertheless, the formulary approach keeps reappearing.

The arm's length standard, based on a transactional determination, has become entrenched in most of the international tax systems of our trading partners, reflected in bilateral tax treaties, in the model income tax treaty agreed to by the OECD, and even in treaties with developing countries, which might benefit from an approach that apportions income from profitable MNCs to less profitable developing country corporations.

In the United States, several developments have modified some of these concepts in practice. In many U.S. transfer pricing cases that have reached the courts, the judges have looked not only at the transactions in question, but also at the combined impact on the parties to the transaction, and have split the profits between the related parties in some broad fashion. Both taxpayers and the Service have used economic analysis to justify or prove the correctness of their respective positions on transfer pricing issues.

In 1986 a further sentence was added to Section 482. This sentence requires that the income with respect to the transfer of an intangible, whether by sale or license, must be "commensurate with the income attributable to the intangible." The objective of this provision is to ensure that MNCs, particularly those in the pharmaceutical or other high technology industries, do not transfer the fruits of their research to foreign manufacturing subsidiaries, which, in the case of "blockbuster" inventions, can then earn extremely high profits, while the U.S. parent gets a flat royalty. The new provision has been interpreted to require that licensing agreements between related parties must be kept open and "periodic" adjustments made to royalty rates in future years reflect the commensurate-with-income standard. Since such open-ended licensing agreements are rare between independent parties, this interpretation represents a significant departure from the arm's length standard and has been much criticized by U.S.-based MNCs and our trading partners.

Meanwhile, in 1994, the Service issued complex regulations to replace much of the 1968 Regulations. These regulations seek not only to supersede certain unfavorable court decisions, but, also, to some extent, to replace the transactional approach almost entirely with a financial results approach, looking to the net income from a transaction or business, rather than the arm's length price for a particular transaction. The technique for analyzing the results is functional and financial analysis, which relies on sophisticated economic analysis by economists. Although our trading partners also rely on economists and use results-oriented methods in the examination of transfer pricing, none has used these techniques to the same extent as the United States, or elevated them to the same level of importance in transfer pricing examinations.

The recent initiatives of the United States government in transfer pricing have made this subject one of the greatest concerns to MNCs and governments alike. The OECD, of which the United States is a member, has itself prepared a new study on transfer pricing, to replace its prior reports on the subject. This will reflect the acceptance, modification, or rejection of various aspects of the new U.S. concepts and will certainly have an impact on the U.S. approach.

It is essential that all countries agree as far as possible to a common approach to transfer pricing, in order to prevent massive double taxation and heavy penalties. It is the purpose of this book to provide the reader with a comprehensive review of the U.S. tax situation with respect to transfer pricing, to enable both U.S. and foreign MNCs to conduct their operations so as to avoid double taxation and penalties, and to plan their international strategies to their best advantage.

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1.04 TYPICAL TRANSFER PRICING ISSUES

Transfer pricing issues can and do arise with respect to the movement of any type of goods, intangibles, services, or capital across international borders, where there is value or benefit on either side of the transaction. The range of issues is limited, in this context, only by the creativity and resourcefulness of the person planning or reviewing the transaction. In the "situations" section of this chapter, several hypothetical situations are set forth for the purpose of illustrating and explaining the various issues and principles to be discussed throughout these materials. The first of those hypotheticals is noted here in order to briefly outline the types of issues that typically arise in the pricing context.

In Situation 1, OilCo is a U.S.-based MNC that has a wholly owned foreign subsidiary engaged in the crude oil exploration and production business in an operating area (ProdCo). ProdCo loads crude on vessels owned by another foreign subsidiary (ShipCo), which transports the crude to a refinery owned by a third foreign subsidiary of OilCo (RefCo). RefCo in turn refines the crude and sells resultant products to foreign affiliates throughout its operating area; Situation 1 raises a broad range of pricing issues that may be important to the United States (where OilCo files a consolidated return), as well as to each country where a subsidiary is organized or conducts operations. Such issues include the following:

1.Sale of goods (e.g., crude oil and refined products) Each sale raises a pricing issue. For example, the sale of crude by ProdCo to RefCo in Situation 1 raises the question whether the price per barrel represents an arm's length price, the answer to which will be important to the country in which ProdCo does business, as well as to RefCo's country. If the former is a low-tax country and the latter is a high-tax jurisdiction, there may be an incentive to try to structure the arrangement so that as much income as possible is earned in the low-tax country. In the case of a commodity such as crude oil, the pricing issue should be reasonably straightforward because there are readily available posted prices.

2.Provision of services The provision of shipping, technical, administrative, or other services raises similar issues to those described in item 1, though the pricing issues may be much more difficult because of the often subjective nature of the value of services, especially routine matters.

3.Use of intangible property (e.g., exploration and development, shipping, refining, and marketing technology) The use of intangible property is perhaps the most complex area of pricing law and practice. Intangible property arises on a broad spectrum. Items such as patents, trademarks, trade secrets, and the like are easily identifiable. On the other hand, other types of intangibles can be far more obscure. Assume that an OilCo executive spends a period of time in the RefCo facilities helping to determine how to refine a new product to be used as a feedstock for a petrochemical plant to be built adjacent to ProdCo's refinery by ProdCo. It may ultimately seem clear that the resultant formula is a valuable intangible asset, but it may be quite unclear who owns it and should enjoy the economic return earned when the formula is used by ProdCo, OilCo, or other affiliates. This uncertainty provides an interesting planning opportunity for the OilCo tax executives, as well as for the pertinent tax inspectors.

4.Financial transfers (e.g., loans, accounts receivable, and accounts payable) In this type of situation, there is a wide range of issues relating to the use of money or capital, each of which can raise pricing issues that may seem simple at first glance, but, as is usual with taxation matters, is far more complex when carefully examined.

All the preceding issues could also arise in situations involving noncontrolled companies or joint ventures. Each country touched by the extended OilCo operations may want to tax an appropriate portion of the profits earned in connection with these matters by companies that are deemed to do business within its borders.

1.05 EVOLUTION OF TRANSFER PRICING ISSUES

The issues briefly illustrated in ¶ 1.04 have been the subject of examination by U.S. and foreign tax administrators for many years, as illustrated by the veritable legion of cases that have been decided under Section 482 and its predecessors. The sheer bulk of these cases attests to the contentiousness that pricing issues can raise in the infinite variety of circumstances involving affiliates.

There is nothing new about the types of pricing issues that have recently become so prominent. Indeed, the essence of the pricing issue--the amount of income that a related party will report from a particular transaction--is endemic to any tax system that respects the separate entityship of business organizations (or trusts, estates, or individuals for that matter). Once this point has been determined, which it inevitably has in the absence of special regimes applicable at the election of the affected taxpayers or the tax administrator (such as the current consolidated income tax regime in the United States), the ability to cause one or another related party to report income in a specific situation is a critical foundation of effective tax planning and tax administration.

In the United States, related-party pricing issues have existed for as long as there has been an income tax. In the early revenue acts, Congress struggled with the matter. The typical issue in the first forty years of the U.S. income tax was how income should be reported among two or more related parties where one or more were not members of a consolidated group. Similar issues existed between individuals and controlled corporations, and other entities.

Since the early 1970s, the heart of the pricing issue in the United States and in most other countries has involved affiliates in the international context, where a single, worldwide business may be conducted in many different countries. In this context, the worldwide effective tax rate incurred by the overall group may depend, in part, upon the ability of the group to arrange its affairs so that it can benefit to the greatest extent possible from the lowest tax regime available. This would be much less important if the effective tax rates in all countries were the same. That is certainly not the case and it seems likely that it will be many years before it is even possible to consider whether such a world should, or could, emerge. If it did, this issue would, no doubt, continue to exist in one form or another; there will always be areas that are not part of any order and offer tax incentives for economic activity.

The transfer pricing requirements of Section 482 traditionally have been difficult for taxpayers to satisfy, the Service to administer, Congress to evaluate, and the courts to resolve. This difficulty stems from the need to treat entities under common control as though they were dealing with each other on an arm's length basis. There appear to be at least two developments over the last fifty years, however, that have led to the heightened awareness that has existed in the transfer pricing area in recent years: first, the post-World War II tendency of the U.S. government to see transfer pricing primarily as an "outbound" issue affecting U.S.-based MNCs; and second, the tendency of taxpayers and the Service to seek the theoretically right price that satisfies the arm's length regulations under Section 482.

After World War II, U.S. business expanded dramatically in the international economy. Manufacturing, marketing, and development of intangibles during this era of U.S. expansion were clearly emanating from the United States. Also, as the tax rates in the United States were extremely high after the war, and in an effort to be closer to their market, U.S. business sought to improve its competitiveness by transferring operations abroad. Predictably, the Service and Congress took steps to prevent what they viewed as the resulting erosion of the tax base through examination, litigation, legislation, regulations, and tax treaties that focused on preventing tax avoidance by U.S.-based multinationals.

History may tell us that the high-water mark of this outwardly focused transfer pricing policy occurred in the Tax Reform Act of 1986, with the so-called super-royalty provisions and commensurate-with-income requirement. Again, if the manufacturing, marketing, and management of intangibles are located in the United States, these new commensurate-with-income standards may benefit the U.S. tax collector. However, if the intangibles are owned by foreign-based corporations, the impact on the fisc is likely to be adverse. Nevertheless, the United States is bound by treaty obligations to apply its tax laws even-handedly to U.S.- and foreign-owned capital.

This phenomenon may account for a major part of the present difficulties as the U.S. government begins to focus on the increasing competition from foreign corporations entering U.S. markets. To its credit, the Service has not suggested that a double standard be adopted--one for outbound transactions by U.S.-based MNCs and another for offshore-based MNCs doing business in the United States. The attitude of Congress, however, has been hardening on this issue. Two sets of public hearings held by the House Ways and Means Oversight Subcommittee, in August 1990 and in April 1992, raised the public consciousness about inbound transfer pricing and tax avoidance issues. These concerns about potential tax avoidance by foreign MNCs, which are competing in U.S. markets, emerged at a time when other events caused the United States to be economically defensive. It is for these reasons that some have suggested that Congress might take action in the transfer pricing area unless the Treasury Department can make a convincing case that the situation is not as bad as it seems.

To its credit, the Treasury Department has urged caution until it can determine (1) the causes and extent of any noncompliance by offshore-based firms operating in the United States and (2) whether the additional enforcement measures and programs added in recent years will be effective to increase such compliance. If the Service is not given additional time, and Congress acts, perhaps precipitously, in the transfer pricing area, there would be repercussions for U.S. as well as offshore-based MNCs.

The second post-World War II development that appears to have contributed to the present crisis of confidence is the apparent tendency of taxpayers and the Service to focus on the right transfer price. This tendency has caused the Service and taxpayers to resort to continued, expensive administrative and courtroom controversies in attempting to establish the most appropriate arm's length price. It has also caused policymakers to promulgate increasingly complex regulations and other forms of guidance to establish criteria to determine the right transfer price. The governments represented in the OECD are, in turn, considering their response to the U.S. initiatives.

At the present time, it has become rather apparent that transfer pricing issues continue to be the most prominent international taxation matter, from planning and examination standpoints, in the United States as well as in most other developed countries. Later surveys have indicated that the lack of uniformity and consistency in transfer pricing enforcement is the most important international tax issue.