

Alert

Transfer Pricing Studies Require Necessary Tax Return Documentation

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Planning and developing supportable transfer pricing within a multi-state or multinational business group has become a key area of concern both for taxpayers and tax authorities. Taxpayers view transfer pricing as providing opportunities for tax planning while tax authorities around the world are uniformly concerned with shifting taxable income outside their jurisdictions. A practical compromise to the tension between taxpayers and tax authorities has been the implementation of rules providing for proper documentation of transfer pricing policies and procedures to facilitate the audit of these policies and procedures by the tax authorities.

The United States has taken the lead on the documentation issue over the last several years by both expanding its statutes and regulations governing documentation requirements for tax returns and emphasizing audits of this documentation. A review of these documentation rules and related tax penalty provisions illustrates the importance of an independent transfer pricing study to prepare proper transfer pricing documentation and avoidance of onerous tax penalties.

The U.S. tax rules on documentation to protect against penalties and persuade against adjustments are contained in Section 6662 and the regulations issued thereunder. The portions of these rules dealing with transfer pricing provide for tax penalties where it is ultimately shown that the tax return understates the tax liability due to transfer pricing policies and procedures. The misstatement generally takes the form of inappropriate consideration paid or received in a transaction with a controlled party or an unsupported adjusted tax basis or value of property sold to a controlled party. The misstatement can be due to a specific intercompany transaction analyzed separately (transactional adjustment) or due to a net misstated position consisting of pluses and minuses to correct a series of intercompany transactions between a controlled party and the U.S. taxpayer (net adjustment).

The transactional misstatement is measured against the amount of the corrected consideration, adjusted tax basis or value as the case may be. If the amount is in excess of 200% or 50% or less of the corrected amount a penalty of 20% of the additional tax can be imposed. If it is in excess of 400% or 25% or less of the corrected amount a penalty of 40% of the additional tax can be imposed. If the net adjustment is greater than the lesser of \$5 million or 10% of gross receipts, the 20% tax penalty can apply. If it is greater than the lesser of \$20 million or 20% of gross receipts the 40% tax penalty can apply. A minimal threshold amount of \$10,000 for regular C corporations and \$5,000 for others applies but in reality this threshold is almost irrelevant.

Tax penalties in the 20% - 40% range can be avoided if the taxpayer proves that it acted "reasonably and in good faith" in establishing its transfer pricing policies and procedures. This reasonableness standard is applied differently for transactional misstatements than for net adjustment misstatements. The reasonableness standard for transactional misstatements is a bit

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bit more lenient than for net adjustment misstatements. It applies a facts and circumstances test which focuses on the taxpayer's efforts to determine proper tax liability. A key factor in making this determination is whether the taxpayer has relied upon professional analysis in establishing its transfer pricing. The reasonableness standard for the net adjustment misstatements is stricter to the extent it requires the taxpayer to in effect rely on a professional analysis that applies a recognized best method of transfer pricing identified pursuant to the requirements of the Section 482 transfer pricing regulations. A penalty can be avoided for a transactional misstatement if the taxpayer in that case adheres to this standard.

The underlying rationale for penalty avoidance, therefore, for either a transactional or net adjustment misstatement, is proper transfer pricing analysis. Whether or not the analysis is in fact proper is dependent on specific factors which focus on the reasonableness standard itself. These factors include the experience and knowledge of the taxpayer, the extent to which accurate data was available and used, the extent to which the specific requirements of the Section 482 transfer pricing regulations were followed, the extent to which the taxpayer relied on a professional qualified to perform the analysis, and the extent to which arbitrary decisions or application of guidance from the analysis are avoided.

Valuation Research Corporation's Transfer Pricing Practice conducts all aspects of transfer pricing documentation within the above parameters to insure that the client's transfer pricing policies and procedures can be used for tax planning. Our transfer pricing professionals and economists – some of whom actually worked for the IRS – can review your current documentation to ensure compliance with the transfer pricing and transfer pricing penalty regulations. The review process includes:

- * Analysis with respect to whether the transfer pricing documentation describes all applicable intercompany transactions.
- * Due diligence with respect to functions performed and risks assumed, including an analysis of Form 5471, Form 5472, and other relevant internal documentation.
- * Determination that the method chosen was indeed the best method.
- * Review of economic analysis to examine the appropriateness of the comparables (including a brief review of 10-K data), the accuracy and/or need for any adjustments, and the viability of the conclusion.

For further information about our transfer pricing services, contact your Valuation Research representative or Jeff Trader at (414) 221-6250. **VR**

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