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2022 KAPAL Webinar

Transfer Pricing

Notice

The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

U.S. transfer pricing regulations

What is Transfer Pricing?

— The price at which goods, services, intellectual property or financial products are transferred between companies in a controlled transaction
  - Purchase/sales of raw materials, finished goods, fixed assets, etc.
  - Provision/receipt of services such as management service, technical support, contract R&D service, logistics service, etc.
  - Payment/receipt of royalty
  - Payment/receipt of interest, loan guarantee service fee, etc.

— Why is it important?
  - Important factor to determine taxable income
  - More focus on TP issues during tax audit
  - Globalization
  - Tax savings

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What is Transfer Pricing? (Cont'd)

— How to determine transfer prices
  - Arm's-length standard
  - OECD Transfer Pricing Guidelines
  - Transfer Pricing Methods (TPMs)

— Requirements related to transfer pricing
  - Form 5471, 5472
  - TP adjustment in tax return
  - FIN 48 (reserve for TP risk)
  - Submission of TP documentation to the IRS within 30 days from a request
  - Contemporaneous documentation

What is Transfer Pricing? (Cont'd)

— What are the risks related to transfer pricing?
  - TP adjustment based on arm's-length price
  - Penalty on TP adjustment
    - 20%/40% of underpayment under U.S. rules
  - Double taxation

— What can a taxpayer do?
  - Planning
  - Contemporaneous documentation
  - Advanced Pricing Agreement (APA)
  - Audit defense
  - Appeal
  - Mutual Agreement Procedure (MAP)

Section 482 today

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

The structure of the regulations today

— Reg. sec. 1.482-1 – General rules applicable to all types of transactions
— Reg. sec. 1.482-2 – Loans
— Reg. sec. 1.482-3 – Tangible property
— Reg. sec. 1.482-4 – Intangible property
— Reg. sec. 1.482-5 – Comparable profits method
— Reg. sec. 1.482-6 – Profit split method
— Reg. sec. 1.482-7 – Cost sharing regulations
— Reg. sec. 1.482-8 – Examples of best method rule
— Reg. sec. 1.482-9 – Services

Arm's-length standard

— Language of Reg. sec. 1.482-1(b)(1) :
  - ...the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.
  - A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized [by] uncontrolled taxpayers…

— An adjustment under Code § 482 is applicable if transfer price charged is not "arm's length."

Transfer pricing methods

— General principles

- The regulations describe methods (“specified methods”) that may be used to price transactions involving particular items: tangible property, intangible property, loans, services, and cost sharing arrangement.
- Taxpayer can chose to apply an “unspecified method” if that is the “best method.”

The best method rule

- The 1994 final regulations use a “best method” rule where method is selected that provides the most reliable measure of an arm’s length result. Primary factors to take into account are:
  - Degree of comparability between the controlled transaction and any uncontrolled comparables; and
  - Quality of the data and assumptions used in analysis (e.g., completeness and accuracy of data, reliability of the assumptions)
- The best method
  - achieves an answer that best approximates arm’s length
  - using the most reliable data
  - with the fewest adjustments to the data

Comparability

- The regulations require consideration of all factors that could affect prices or profits in arm's length dealings. General comparability factors are:
  - Functions performed
  - Contractual terms
  - Risks taken
  - Economic conditions
  - Property or services

- Where differences exist between controlled and uncontrolled transactions that have a material affect on price, adjustments must be made, if possible.
  - The inability to make adjustments to reflect differences impairs the reliability of the comparable.

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Transfer pricing methods under the U.S. transfer pricing regulations

Unit of Measurement	Tangible	Intangible	Services	OECD
Price	Comparable uncontrolled price (CUP) method	Comparable uncontrolled transaction (CUT) method	Comparable uncontrolled services price (CUSP) method	Comparable uncontrolled price (CUP) method
Gross Profit on Sales	Resale price method (RPM)	N/A	Gross services margin method (GSM)	Resale price method (RPM)
Gross Profit on Costs	Cost plus method (CPLM)	N/A	Cost of services plus (CSPL) method	Cost plus method (CPLM)
Net Profit of One Party	Comparable profits method (CPM)	Comparable profits method (CPM)	Comparable profits method (CPM)	Transaction net margin method (TNMM)
Net Profit of Both Parties	Profit split method (PSM)	Profit split method (PSM)	Profit split method (PSM)	Profit split method (PSM)
Other	Unspecified method	Unspecified method	Services Costs Method (SCM); Unspecified method	Unspecified method

Transfer Pricing Example in Life Science Industry

— U.S. subsidiary licenses the right to further develop and commercialize a new drug from its Korean parent company
  - Korean company developed a new drug, which is approved in Korea
  - U.S. subsidiary wants to have the new drug approved by the FDA and sell it in the U.S. market

— Royalty needs to be determined at arm's length
  - Comparable third party agreements
  - Different success rates in phases

Thank you

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