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Preparing Multinational Companies for Transfer Pricing Audits of Intangibles

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PREPARING MULTINATIONAL COMPANIES FOR TRANSFER PRICING AUDITS OF INTANGIBLES

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I. PURPOSE

This article provides guidance for multinational companies concerned about transfer pricing audits of intangibles, such as patents[2] and trademarks.[3] Advice focuses on assisting companies to prepare for a transfer pricing analysis to avoid potential tax problems with government auditors. This anticipatory perspective emphasizes the importance of detailed transfer pricing documentation. Advisers must understand what is likely to trigger a transfer pricing audit, particularly for intangibles, and how to respond to a transfer pricing audit. Encouraging multinational companies to enter into an Advance Pricing Agreement with selected governments should help minimize audit problems. Advisers should view litigation more as a last resort, even though in the case of intangibles, multinational companies often win at least a partial victory.

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[2] A patent provides various legal rights granted by a government to the patent owner to protect innovative technology. *See, e.g.*, 26 C.F.R. § 1.482-84(b)(1) (2005).

[3] Trademarks exist to identify and protect a company's goods. *See, e.g.*, 26 C.F.R. § 1.482-84(b)(3) (2005).

II. INTRODUCTION

Recently, transfer pricing audits[4] have occurred more frequently throughout the world; during the period 2000 to 2003, nearly half of all parent corporations[5] of multinational companies[6] underwent a transfer pricing audit somewhere in the world.[7] In addition, three-fourths of multinational companies surveyed expected a transfer pricing audit during the next few years,[8] anticipating even stricter government enforcement.[9] The fact that the U.S. and U.K. are now complaining more about transfer pricing

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[4] An "audit" is an examination to obtain reasonable assurance to express an opinion. It typically involves planning, assessing internal controls, collecting evidence, and reporting the results. *Cf.* CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 1, § 150.02 (Am. Inst. Of Certified Pub. Accountants 1972), *available at* http://www.aicpa.org/download/members/div/auditstd/AU-00150.PDF (last visited Mar. 16, 2006) (standards of fieldwork and standards of reporting). Various types of audits exist, such as financial audits and compliance audits. A "transfer pricing audit" is a type of tax audit that examines a multinational company's financial statements and tax reporting compliance on transfer pricing authority to determine if the company needs to make adjustments for tax purposes. A multinational company may conduct its own internal transfer pricing audit, however, more commonly, and as used in this article, government tax auditors conduct external transfer pricing audits.

[5] A parent corporation is often a global holding company, which is not necessarily located where the multinational company's major headquarters for business operations are located.

[6] A multinational company consists of corporations or similar multinational enterprise organizations operating in more than one country. *Compare* OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, at G-6 (Glossary) (1998) [hereinafter OECD GUIDELINES].

[7] *See* Venessa Houlder, *U.S. Revenue Service Gets Tougher on Multinational Manoeuvers to Avoid Tax*, FIN. TIMES, Feb. 3, 2005, at 5.

[8] *See* ERNST & YOUNG, TRANSFER PRICING 2003 GLOBAL SURVEY 7 (2003) [herinafter GLOBAL SURVEY]. More frequently targeted for tax audits are the multinational companies from Switzerland, the Netherlands, the U.S., Sweden, and France. *Id.* at 11.

[9] In fiscal year 2004, IRS enforcement efforts brought in a record $43.1 billion in enforcement revenue. Mark W. Everson, IRS Commissioner, *Enforcement Revenue Reaches Record in 2004* (prepared remarks)(Nov. 18, 2004). For fiscal year 2006, President Bush proposed an eight percent increase in enforcement funding while the IRS as a whole would receive only a four percent increase. *See* ALLEN KENNEY, IRS ENFORCEMENT GETS BUDGET BOOST; SERVICE, MODERNIZATION NOT SO LUCKY (2005), http://services.taxanalysts.com/taxbase/nav.nsf/TNTFrame?Open &Login. The global economy challenges the IRS to assure the proper assessment and collection of worldwide income taxable to the United States. I.R.S., THE BUDGET IN BRIEF: FY 2006, 8 (Feb. 2005).

audits conducted outside their home countries rather than inside them[10] illustrates the expansion of audits and underlines the importance of proactive preparation.

The increase in transfer pricing audits is itself an indication of the increasing importance of transfer pricing. In recent years, the number of transfer pricing audits has dramatically increased in many countries (e.g., France);[11] moreover, some countries have expanded their transfer pricing focus to include small to medium-sized multinational companies (e.g., Australia).[12] In some countries, transfer pricing audits occurred for the first time in this period (e.g., India[13] and Colombia).[14] Aside from the greater number of audits, the audits themselves are more aggressive in many countries,[15]

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[10] *See Competent Authority: Glaxo Case Not Seen Causing Harm to U.S.-U.K. Competent Authorities' Relations*, 14 TAX MGMT. TRANSFER PRICING REP. 11 (May 11, 2005). In 2004, multinational companies filed twice as many complaints with the U.S. competent authority about transfer pricings audits outside the U.S., resulting in adjustments to the affiliated foreign multinational company, as compared with complaints about U.S.-initiated transfer pricing adjustment cases. *See Competent Authority: U.S., U.K., Japanese Officials Endorse Binding Arbitration for Unresolved MAP Cases*, 13 TAX MGMT. TRANSFER PRICING REP. 863 (Dec. 22, 2004) (statement of Robert Green, IRS, Large and Mid-Size Business Division, Director – International).

[11] *See, e.g.*, Gianmarco Monsellato, *Transfer Pricing Audits on the Rise*, 28 TAX NOTES INT'L 524 (2002) ("[T]ransfer pricing audits in France increased by 520% between 2000 and 2002"). *See also France Remains Europe's Toughest Enforcer on Transfer Pricing Issues, Practitioner Says*, 13 TAX MGMT. TRANSFER PRICING REP. 301 (Aug. 4, 2004). *But see France Limits Audits to Nine Months for Most Taxpayers, Gives More Rights*, 14 TAX MGMT. TRANSFER PRICING REP. 55 (May 25, 2005).

[12] The Australian Taxation Office outlined its compliance program for 2004 to 2005 to improve transfer pricing compliance with small to medium-size enterprises. *See* Paul Riley et al., *Australia Steps Up Transfer Pricing Activity*, THE ARM'S LENGTH STANDARD 3 (Feb. 2005) (Deloitte Touche Tohmatsu Ltd., Australia).

[13] *See* Ashish Aggarwal, *Transfer Pricing: A New World Order*, BUSINESSWORLD, Dec. 8, 2003, *available at* http://www.businessworldindia.com/Dec0803/indepth02. asp.

[14] Ricardo Rosero, *Colombia's New Transfer Pricing Rules: A Sophisticated Approach*, 11 TAX MGMT. TRANSFER PRICING REP. 937 (Mar. 5, 2003).

[15] Aggressive enforcement of transfer pricing has occurred in Japan, Australia, South Korea, and China. *See* Steven Harris et al., *The Path to Resolving Transfer Pricing Conflict*, INT'L TAX REV., *available at* http://www.internationaltaxreview.com/?Page=17&ISS=13156&SID=488112 (last visited Jan. 21, 2006). In South Korea, intense scrutiny and lack of sufficient documentation often resulted in denied deductions for a significant portion of a multinational company's management service fees. *See* Henry An, *Korea's New Basic Rulings on Transfer Pricing*, 13 TAX MGMT. TRANSFER PRICING REP. 343 (Aug. 4, 2004). However, in 2004 South Korea's concern about attracting foreign investment led to modifications to enhance consistency and

especially during the past few years (e.g., Korea).[16] Greater rigor may be the result of auditors receiving sophisticated international tax training on transfer pricing audits (e.g., Thailand).[17] Growth in transfer pricing audits and enhanced audit enforcement is expected to continue in the near future.

Multinational companies can therefore expect a larger number of audits throughout their organization and should be aware of the continually evolving nature of audits. Transfer pricing audits in some countries have switched from an exercise in documentary compliance to an examination of the substance of the reporting (e.g., Mexico).[18] Elsewhere, the focus may be a combination of form and substance, which causes auditors to request transfer pricing documentation at the start of corporate audits (e.g., U.S.).[19]

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predictability. Separate transfer pricing audits will no longer occur if no indication exists that the taxpayer intentionally manipulated transfer prices. South Korea also reduced the scope of transfer pricing audits from five to three years. *See Korea*, ASPAC TAX NEWSL. (KPMG Int'l, Asia Pac.), Oct. 2004, at 12–14, http://www.kpmg.or.jp/resources/newsletter/tax/aspac200410_e.pdf.

[16] The Korean National Tax Service (NTS) aggressively challenges situations in which a Korean manufacturing affiliate is converted into a contract manufacturer, a limited-risk distributor is claimed, or a multinational company uses non-Korean comparables. *See Korea: Officials Challenging Commissionaires, Say Activities Create PE, Practitioner Says*, 13 TAX MGMT. TRANSFER PRICING REP. 299 (Aug. 4, 2004) (statements of Yoon Hwan Son, Deloitte & Touche's Seoul office). *See generally Korean National Tax Service's Basic Rulings for Transfer Pricing* (Samil PricewaterhouseCoopers trans.) (released June 15, 2004, Seoul).

[17] *Thailand*, 13 TAX MGMT. TRANSFER PRICING REP. 940 Special Report No. 45 (Jan. 19, 2005). As more tax officials in Thailand receive training in Australia, intangibles are expected to receive more attention. In addition, more valuation issues will arise when reviewing licensing agreements. *Id.*

[18] *See* Oscar Campero et al., *Mexico Takes New Approach to Transfer Pricing Audits*, 36 TAX NOTES INT'L 861, 861–62 (2002). Although Mexico established a transfer pricing regime in 1997, it was not until after the Organisation for Economic Cooperation and Development (OECD) review that it established transfer pricing standards on intangibles. *See* Moisès Curiel et al., *SAT Publishes New Standards on the Migration of Intangibles*, 5 PRAC. LATIN AM. TAX STRATEGIES 1 (Mar./Apr. 2005) *available at* http://www.wtexecutive.com/cms/content.jsp?id=com.tms.cms.section.Section_1021; *see also* OECD, PEER REVIEW OF MEXICAN TRANSFER PRICING LEGISLATION AND PRACTICES ¶ 12 (Mar. 2003), http://www.oecd.org/dataoecd/29/16/34244429.pdf.

[19] U.S. international examiners are to issue a written information document request for a copy of any transfer pricing documentation prepared by the taxpayer pursuant to section 6662(e) at the joint opening conference for each audit cycle. *See* Larry Langdon, *Memorandum for LMSB Executives, Managers, and Agents re: Transfer Pricing Compliance Directive* (Jan. 22, 2003), http://ftp.qai.irs.gov/pub/irs-utl/transfer_

Transfer pricing concerns assert increasing influence on tax treaties. These concerns have triggered revisions, as in the case of Japan,[20] and even termination, as shown by Germany's 2005 decision to end its bilateral tax treaty with Brazil.[21] Because the application of tax treaties to large companies is vital, governments ensure consistency by involving their tax-treaty personnel in the negotiation of large transfer pricing agreements.[22]

While literature exists on general transfer pricing concerns and methods, this is the first law review article to provide in-depth information and advice on transfer pricing audits for intangibles. Addressing transfer pricing audits of intangibles from a worldwide perspective is particularly helpful in advising multinational companies engaged in strategic planning.

Part III of this article will examine preparation for transfer pricing audits of intangibles and the required analysis and documentation. Part IV will discuss the problem of transfer pricing audit triggers and the audit itself. It will also offer suggestions on how auditors and governments should proceed. Part V will

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pricing_compliance_directive_03.pdf. Previously, examiners requested documents in thirty-five percent of the transfer pricing cases. More recently, they sought documents in fifty-five percent of the cases. KPMG LLP (U.S.), *IRS Targets Transfer Pricing Compliance*, INT'L TAX REV. (Dec. 2004/Jan. 2005), *available at* http://www.internationaltaxreview.com/?Page=10&PUBID=35&ISS=12594&SID=470552&TYPE=20.

[20] *See* Charles Cope & David F. Chan, *An Analysis of the New Japan-United States Income Tax Treaty*, 32 TAX NOTES INT'L 1119 (2003) (the revised tax treaty provides a time limit provided for making transfer pricing adjustments). Transfer pricing concerns in Japan extend beyond the U.S. treatment of Japanese multinational companies. For example, Japan imposed transfer pricing adjustments on multinational corporate group Suzuki in connection with its subsidiaries in South Africa, Colombia, Hungary, and Indonesia. The Toyota multinational corporate group had a Japanese assessment based on fees paid to its Singapore marketing subsidiary. *See Japan Expanding Transfer Pricing Probes*, 12 TAX MGMT. TRANSFER PRICING REP. 522 (Oct. 15, 2003).

[21] *Tax Treaties: Germany Cancels Tax Treaty with Brazil, Gives Transfer Pricing Disputes as Reason*, 13 TAX MGMT. TRANSFER PRICING REP. 1230 (Apr. 27, 2005) (Germany contended that Brazil's minimum profit margin requirement for related party transactions violated the arm's length principle, distorted risk allocations, and failed to reflect an open market). Deductibility of royalties and similar expenses in Brazil is limited to ranges between one and five percent. *See* Napoleao Dagnese & Carlos Eduardo Ayi, *An Approach to Brazilian Transfer Pricing Practice*, 13 TAX MGMT. TRANSFER PRICING REP. 701 (Oct. 27, 2004).

[22] I.R.M. 42.10.8.1.5, *Negotiation and Approval of Bilateral and Multilateral APAs* (Nov. 15, 1996), *available at* http://www.irs.gov/irm/part42/ch10s08.html.

investigate transfer pricing audits from both an administrative (focusing on Advance Pricing Agreements (APAs)) and judicial context (reviewing major cases and illustrating the risks of litigation).

III. PREPARING THE TRANSFER PRICES OF INTANGIBLES FOR TAX PURPOSES

In anticipation of audits, companies need a clear and uniform approach to transfer pricing. To get started in the right direction, an adviser must meet with the appropriate company officials to determine the appropriate transfer pricing method[23] to use in establishing the company's transfer prices. In addition to clarifying who is responsible for implementing any changes and gathering necessary information, this discussion should also consider the potential financial results of this method and the information needed to provide the best support for these prices.[24]

A. General Transfer Pricing Analysis and Its Complexities

In a transfer pricing analysis, multinational companies usually evaluate transactional facts and circumstances.[25] The analysis generally compares the four factors discussed below: (1) functions, (2) risks, (3) economic conditions,[26] and (4) contractual terms.[27] The relative importance of these factors depends on the pricing method used.[28] For property or services,[29] the analysis should also determine if any "embedded intangible" exists.[30]

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[23] Because transfer pricing methods are widely discussed in current literature, this article does not discuss them.

[24] H. Thomas Davis, *Transfer Prices in the Real World—10 Steps Companies Should Take Before It's Too Late*, 64 CPA J. 82 (Oct. 1994), *available at* http://www.nysscpa.org/cpajournal/old/16373972.htm.

[25] 26 C.F.R. § 1.482-1(d)(1) (2005).

[26] Relevant economic conditions should consider the similarity of the geographic markets, the relative size and economic development in each market, whether the market is wholesale or retail, the market shares for transferred items, relevant location-specific costs, competition in each market, and the alternatives realistically available to buyer and seller. 26 C.F.R. § 1.482-1(d)(3)(iv) (2005).

[27] 26 C.F.R. § 1.482-1(d)(3)(ii) (2005).

[28] Companies must conduct an analysis on the functions and risks of the various parties to the transactions. Governments usually expect companies to acquire

1. Functions

A "functional analysis"[31] helps identify the factors that create value in the intangible, the identity of the owner, the true nature of the property transferred, and the terms and conditions under which a related party uses the intangible.[32] A functional analysis also identifies significant economic activities and the functions of related and unrelated taxpayers to determine the comparability of their transactions.[33] Nevertheless, a functional analysis is not usually concerned with unrelated third-party transactions because each intangible is arguably unique.

In performing the functional analysis, a multinational company should take into account that government tax auditors will probably interview the operational personnel most familiar with the multinational company's operations,[34] as well as the preparers of the documentation.[35] Because the tax department does not deal with detailed knowledge of products and marketing, the multinational company's analysis and documentation preparation should involve non-tax personnel to ensure accuracy and credibility.

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supporting evidence on the comparability of the transaction *before* selecting the most appropriate pricing method and setting the actual transfer price.

[29] I.R.M. 4.61.3.5.6, *Property or Services* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html.

[30] An "embedded intangible" exists if the value of the tangible property or service is affixed to it, such as a trademark. 26 C.F.R. § 1.482-3(f) (2005).

[31] A functional analysis for intangibles looks at marketing and distribution, advertising, and similar activities. *Cf.* 26 C.F.R. § 1.482-1(d)(3)(i)(F) (2005). Other functions to analyze for intangibles can include research and development, product design and engineering, and embedded management services. *Cf.* 26 C.F.R. § 1.482-1(d)(3)(i) (2005).

[32] *See* Inland Revenue, Transfer Pricing Guidelines: A Guide to the Application of Section GD 13 of New Zealand's Income Tax Act of 1994, 53 ¶ 409 (2000) (New Zealand), *available at* http://www.ird.govt.nz/resources/file/ebde89456c78fc0/apx12-10.pdf.

[33] 26 C.F.R. § 1.482-1(d)(3)(i) (2005). An example of part of the functional analysis is identifying royalty rates for trademarks. *See* Weston Anson, *How to Make Transfer Pricing Work for IP and Intangibles*, INT'L TAX REV. (Oct. 2004), *available at* http://www.internationaltaxreview.com/default.asp?page=10&PUBID=35&ISS=12596&SID=470401.

[34] *See* I.R.M. 4.61.3.5.1, *Functional Analysis* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html.

[35] *See, e.g.*, *Practitioners Say IRS Digging Deeper in Audits of Pharmaceutical Companies*, 14 TAX MGMT. TRANSFER PRICING REP. 83 (June 8, 2005).

2. Risks

A risk analysis evaluates the risks borne by the parties to controlled and uncontrolled transactions.[36] The United States requires companies to perform a risk analysis within multinational corporate groups to determine which party in a controlled transaction bears the associated risks.[37] The analysis must also consider whether income earned by the risk-bearing party is commensurate with the risks assumed.[38]

Market risks are the major risks to consider in each step of the transfer pricing analysis.[39] Market risks include fluctuations in cost, demand, pricing, and inventory levels.[40] As part of this risk analysis, the controlled multinational company's conduct over time must remain consistent with the allocation of risks.[41] In addition, the controlled multinational company must have the financial capacity to absorb the losses that might occur because of the risks assumed.

3. Economic conditions

One economic factor multinational companies typically take into consideration in transfer pricing analysis is comparability adjustments[42] for market share.[43] Governments generally expect

[36] *See generally* Robert T. Cole, *International Strategy for Transfer Pricing Compliance: A Checklist for Multinationals*, *in* PRACTICAL GUIDE TO U.S. TRANSFER PRICING, ch. 26 (Robert T. Cole ed., 2d ed. 2001).

[37] 26 C.F.R. § 1.482-1(d)(3)(iii)(B) (2005).

[38] 26 C.F.R. § 1.482-1(d)(3)(iii)(A) (2005).

[39] Another risk arises if the controlled multinational company exercises managerial or operational control over the business activities that generate the income or loss. 26 C.F.R. § 1.482-1(d)(3)(iii)(B) (2005).

[40] Other risks include those related to the success or failure of research and development activities; financial risks, including fluctuations in foreign currency rates and interest rates; credit and collections risks; product liability risks; and general business risks related to the ownership of property, plant, and equipment. 26 C.F.R. § 1.482-1(d)(3)(iii)(A) 2005.

[41] 26 C.F.R. § 1.482-1(d)(3)(ii)(B)(2) (2005); I.R.M. 4.61.3.5.4, *Contractual Terms* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html.

[42] For information on potential commercial databases to use in finding comparables, see Martine Cools, *International Commercial Databases for Transfer Pricing Studies*, 6 INT'L TRANSFER PRICING J. 167 (Sept./Oct. 1999); Richard A. Clark, *Finding and Analyzing Comparable Financial Data* app. 9C, *in* TRANSFER PRICING HANDBOOK (Robert Feinschreiber ed., 1998).

evidence showing that a market share strategy is likely to produce future profits commensurate with implementation costs. Multinational companies can pursue this strategy for only a reasonably limited amount of time.[44]

Economic condition analysis also includes two other potential adjustments based on geographical market and location savings. Most governments are parochial in preferring transfer pricing product comparisons within the same geographic market; however, some governments allow consideration from the same economic region.[45] Location savings arise from operating in a low-cost geographic location when the cost savings would increase the profits of comparable firms.[46]

4. Contractual terms

Comparability for transfer pricing analysis also requires evaluating significant contractual terms, especially those affecting prices or profits. Examples of significant contract terms include the form of consideration; sales or purchase volume; warranties provided; right to updates; duration, termination, and renegotiation

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[43] Different market share strategies may exist to enter markets, to increase a product's existing market share, or to meet competition, which may affect the price of the intangibles. 26 C.F.R. § 1.482-1(d)(4)(i) (2005).

[44] 26 C.F.R. §§ 1.482-1(d)(4)(i)(A)–(B) (2005). Controlled taxpayers must document (1) the market share strategy, (2) the related costs and expected returns of the strategy, and (3) any agreement between the members of the multinational corporate group to share the related costs *before* they implement the strategy. 26 C.F.R. § 1.482-1(d)(4)(i)(C) (2005). Companies must generally include a statement of the strategy, a detailed marketing plan that addresses resale prices and/or sales promotion activities, a breakdown of related startup costs, a budget that captures expected future profits, a time frame to pursue the strategy given the specific industry and product in question, and written evidence supporting the allocation of risks.

[45] *See* Dirk Van Stappen, *Pan-European Versus Country-Specific Searches and Pan European Versus Country-Specific Databases: Not a Clear-Cut Issue*, 13 TAX MGMT. TRANSFER PRICING REP. 222, 225 (July 7, 2004). If the same country information is not readily available, governments typically allow companies to use information from an uncontrolled transaction in a different, but similar, geographic market with appropriate adjustments for market differences. 26 C.F.R. § 1.482-1(d)(4)(ii)(A) (2005).

[46] The analysis must consider the competitive positions of buyers and sellers. 26 C.F.R. § 1.482-1(d)(4)(ii)(C). *See generally* Diana Jiménez Moncada, *Location Savings: Who Is Entitled to the Additional Profit?*, 2005 TAX PLANNING INT'L TRANSFER PRICING (June 2005).

rights; collateral transactions, such as for ancillary or subsidiary services; and extension of credit and payment terms.[47] Contractual terms may vary for each transaction.

5. Other issues

Apart from the four comparative factors explained above, other issues such as cost sharing arrangements present another set of problems that companies should consider.[48] These problems include which costs are shared, how these costs are shared, which values are attributable to the previously developed intangibles, and what terms are acceptable to the government authorities.[49] In many countries, multinational companies consult with local accountants to determine what royalty rates are acceptable to the government tax authorities[50] and which royalty rate to use for transfer pricing tax purposes.[51] Whereas domestic firms usually set royalties at a uniform rate for tax purposes, multinational commercial companies typically create licenses with tiers of royalty rates based on net sales.[52]

Instead of performing a transfer pricing analysis of each intangible, advisers sometimes recommend bundling each type, such as a technology licenses. Nevertheless, companies should prepare to defend an individual intangible that represents a significant amount of income or expenses, such as more than one percent of the multinational company's gross income. Advisers

[47] 26 C.F.R. § 1.482-1(d)(3)(iii)(A) (2005).

[48] *See* Prop. Treas. Reg. § 1.482-7, 67 Fed. Reg. 48,997 (July 29, 2002). The OECD refers to cost sharing arrangements as "cost contribution agreements."

[49] *See* MONICA BOOS, INTERNATIONAL TRANSFER PRICING: THE VALUATION OF INTANGIBLES 140 (2003).

[50] Kingsley L. Taft, Joint Development Agreements, Presentation at the Practicing Law Institute's Seminar on Patent & High Technology Licensing in New York City (June 1, 2005).

[51] In Italy, royalties under two percent of sales are generally automatically accepted, while additional technical or legal factors, such as exclusive licensing, may justify royalties of up to five percent of sales. Royalties exceeding that amount are justified only in exceptional circumstances, such as licenses for cutting-edge technology or extraordinary facts. *See* Marc M. Levey, *Italian Transfer Pricing Revisited: Differences from U.S. Rules Remain*, 8 J. INT'L TAX'N 20, 23 (1997). Similarly, royalties in Vietnam are limited to a maximum of five percent of the net selling price or twenty-five percent after-tax profit. *See Vietnam*, 13 TAX MGMT. TRANSFER PRICING REP. S-26 (Jan. 19, 2005).

[52] Author's discussion with Kingsley L. Taft, *supra* note 50.

should consider lobbying countries to reward multinational companies that demonstrate integrity and limit scrutiny to companies that fail to assure legal compliance.

B. Documentation of Transfer Pricing: A Necessary Compliance Burden

Conducting a detailed transfer pricing analysis is a costly but necessary process due to the increased importance of documentation of transfer prices. Proper documentation is critical for five major reasons. First, more countries have enacted legal requirements governing documenting appropriate transfer prices.[53] Second, higher transfer pricing penalties may apply if multinational companies lack proper documentation. Third, multinational companies generally bear the burden of proof for their tax positions. Fourth, commercial reasons may exist, such as following best management practices to assure the efficient use of resources.[54] Fifth, documentation helps to reduce retraining costs upon the inevitable departure of critical people within the company. Proper documentation also requires that multinational companies take precautions in drafting the transfer pricing documents for their local companies to protect the confidentiality of their trade secrets and commercially sensitive data.[55]

In general, documentation requirements for tax purposes have increased worldwide.[56] In at least twenty-two countries, multinational companies must prepare transfer pricing

[53] *See* OECD GUIDELINES, *supra* note 6, at ch. V, Documentation (1995); I.R.M. 4.61.4.4 *Taxpayer's Books and Records* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s04.html; *see generally* Marc M. Levey & David Balaban, *Global Documentation–Many Considerations*, ASIA-PAC. TAX BULL. (Jan./Feb. 2004).

[54] *See* TR 95/D23 (Draft Taxation Ruling), *as modified by* TR 98/11 (Australia).

[55] *See, e.g.*, *Parties in GlaxoSmithKline Seek Confidential Information Protective Order*, 106 TAX NOTES 781 (2005); *see also Motions: IRS Must Reveal Number of Allegations of Tax Information Leaks by Japan's NTA*, 13 TAX MGMT. TRANSFER PRICING REP. 794 (Dec. 8, 2004).

[56] Korea is an exception to the trend of increasing document requirements. In 2005, Korea reduced the number of required documents from ten to three (statement of method of arm's length price, statement of international transactions, and summary income statements of foreign-related parties). *See Korea, Revised Documentation Rules by NTA*, 17 TAX MGMT. TRANSFER PRICING REP. S-79 (Jan. 19, 2005).

documentation for related company transactions;[57] and at least fourteen other countries recommend transfer pricing documentation.[58] The Organisation for Economic Co-operation and Development (OECD)[59] created guidelines on transfer pricing. However, the OECD guidelines state, relatively weakly, that "the information relevant to an individual transfer pricing inquiry depends upon the facts and circumstances of each case."[60]

The transfer pricing documentation burden varies among countries, in part because the burden depends on the volume and complexity of documents required by each government. The most common types of documents governments require from multinational companies are just for "basic documentation." Generally, these include a description of transactions with related parties, the transfer pricing method selected for the analysis, an identification of comparables as well as any adjustments to them, and an explanation of the multinational company's economic analysis.[61]

Some countries further require "moderate documentation," which includes an overview of the multinational company's business; a description of the multinational corporate group's organizational structure and other documents, such as those that support the assumptions; conclusions; and positions taken in the multinational company's transfer pricing documents.[62] A few

[57] DELOITTE TOUCHE TOHMATSU, STRATEGY MIX FOR GLOBAL TRANSFER PRICING: PLANNING FOR METHODS, DOCUMENTATION, PENALTIES AND OTHER ISSUES 18–19 (2006) (Countries requiring documentation are Argentina, Australia, Brazil, Canada, China, Colombia, Denmark, Ecuador, France, Germany, India, Israel, Korea, Malaysia, Mexico, the Netherlands, Peru, Philippines, Poland, Portugal, South Africa, Taiwan, the U.K., the U.S., and Venezuela).

[58] *See id.* (Belgium, the Czech Republic, Finland, Italy, Japan, Kazakhstan, New Zealand, Norway, Russia, Spain, Sweden, Taiwan, and Thailand).

[59] The OECD consists of thirty countries with democratic governments and market economies. *See* About OECD, http://www.oecd.org (last visited Mar. 13, 2006).

[60] OECD GUIDELINES, *supra* note 6, ¶ 5.16. A multinational company's documentation files should include any cost-sharing or -contribution agreements, Advance Pricing Agreements (APAs), or rulings from a relevant government. *Id.*

[61] *See id.* at 22–23, tbl.1 ("Categories of Documentation Required"); OECD GUIDELINES, *supra* note 6, ¶ 5.18(iii) (1995) (organizational structure should show ownership linkages within the multinational corporate group).

[62] *See* DELOITTE TOUCHE TOHMATSU, *supra* note 57, at 22–23 (examples of countries with moderate documentation include China, the Czech Republic, France, Germany, Italy, Singapore, Spain, and Venezuela). *See, e.g.*, Peter H. Dehnen & Silke

countries also mandate "extensive documentation," requiring written explanations as to why the company did not select alternative pricing methods, relevant data obtained after year-end, and/or an index to all the transfer pricing documents.[63] Even if it is a good management strategy to require multinational companies to prepare an index to relevant documents, advisers should have their multinational corporate clients lobby to limit the compliance burden in transfer pricing to "moderate documentation."

At least fourteen countries require another form of documentation, referred to as contemporaneous documentation, where taxpayers contemporaneously document their transfer pricing analysis.[65] Contemporaneous documentation usually means the local company completes its documentation by the date the parent multinational company files its income tax return.[66] A contemporaneous documentation requirement reduces discrepancies in appropriate transfer price that the company can otherwise only detect with hindsight.[67] Contemporaneous documentation should also include how the multinational company allocates risks among members of a multinational corporate group.[68]

Bacht, *New Developments Regarding Transfer Pricing Documentation in Germany*, BULL. FOR FISCAL DOCUMENTATION, May 2005, at 185.

[63] DELOITTE TOUCHE TOHMATSU, *supra* note 57, at 22–23. For example, New Zealand, Peru, and the U.S. require a documentation index.

[65] *See* DELOITTE TOUCHE TOHMATSU, *supra* note 57, at 22–23 (indicating that countries requiring contemporaneous documentation include Australia, Canada, China, Germany, Hungary, India, Mexico, the Netherlands, Portugal, South Africa, Thailand, the U.K., the U.S., and Venezuela).

[66] For companies, the cost of contemporaneous documentation can generally range from US$100,000 to over US$1 million. Gordon C. Millbourn III, *Treasury Inspector General for Tax Administration Report on Transfer Pricing*, 12 TAX MGMT. TRANSFER PRICING REP. 532 (Oct. 15, 2003).

[67] To qualify for an exception to the transfer pricing penalties, the multinational company must have used contemporaneous documentation to record a reasonable effort to determine its tax liability accurately in accordance with the required transfer pricing analysis. A failure to provide such documentation to the IRS within thirty days of a request creates the presumption that the taxpayer did not make the required reasonable effort. 26 C.F.R. § 1.6662-6(d)(2)(iii) (2005).

[68] In 2004, Canada issued a directive mandating auditors to request contemporaneous documentation for non-arms-length transactions with non-residents. Can. Revenue Agency, Transfer Pricing Memorandum on Contemporaneous Documentation (Oct. 13 2004), *available at* http://www.cra-arc.gc.ca/tax/non residents/common/trans/tpm05-e.html. The request should occur early in the audit or when the auditor first becomes aware of the transaction. *Id.*

Coordinated "multi-country documentation"[69] represents the efforts of several governments to coordinate the appropriate transfer pricing documentation when they need to analyze activities in multiple countries.[70] Fewer than one-third of multinational companies prepare multi-country documentation even though such documentation might help identify tax-planning opportunities, provide consistency, mitigate audit risks, and result in documentation cost savings.[71] Legal-language requirements are often a hindrance to pursuing multi-country documentation;[72] however, this documentation practice should significantly increase when the European Union (E.U.) eventually adopts a coordinated master-file documentation package for all E.U. countries[73] that permits E.U. countries to require additional local documentation.[74]

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[69] Multinational accounting firms have begun to sell services that prepare "multi-country documentation." For example, PricewaterhouseCoopers refers to its multi-country documentation service as "Global Core Documentation." *See* PricewaterhouseCoopers, Global Core Documentation, http://www.pwc.com/extweb/service.nsf/docid/178390e968285b8f85256fbf00582caa (last visited Mar. 18, 2006).

[70] The Pacific Association of Tax Administrators (PATA) Guidance of March 12, 2003, does not impose any legal requirements greater than imposed by the relevant PATA country (U.S., Canada, Australia, and Japan). Instead, PATA Guidance attempts to prevent costly duplicative administrative requirements. *Pacific Association of Tax Administrators (PATA) Transfer Pricing Documentation Package*, http://www.cra-arc.gc.ca/tax/nonresidents/common/trans/pata-e.pdf (last visted Mar. 18, 2006).

[71] *See* GLOBAL SURVEY, *supra* note 8, at 21. *See generally*, Gregory J. Ossi et al., *The Search for Consistency: A Global Approach to Transfer Pricing Documentation*, 32 TAX MGMT. INT'L J. 283 (2003).

[72] Many countries do not accept transfer pricing documents in a foreign language (e.g., Greece and Portugal). Some countries will accept documents in English or another specified foreign language (e.g., Belgium and Spain). Other countries may require translation at the discretion of the tax administrator (e.g., Finland and Austria). *European Union: Survey Finds EU Members Disagree Widely on Applying Arbitration Convention Provisions*, 12 TAX MGMT. TRANSFER PRICING REP. 131 (June 23, 2003).

[73] In 2006, the E.U. is expected to adopt a proposed *EU Transfer Pricing Documentation* policy (where the E.U., not the U.N., must be modified). U.N. JTPF, 21st Sess., 9th mtg., U.N. Doc JTPF/021/2004/EN (Sept. 16, 2004); *accord EU Governing Body to Vote This Fall on EU Forum's Documentation Proposal*, 14 TAX MGMT. TRANSFER PRICING REP. 16 (May 11, 2005).

[74] *See* E.U. Joint Transfer Pricing Forum, Draft Revised Secretariat Discussion Paper on the Masterfile Concept 10 ex.1, U.N. Doc JTPF/003/REV3/2004/EN (Sept. 16, 2004). The reduced documentation should contain a transfer pricing analysis and all inter-company agreements. This includes licenses, services, contract research, and distribution agreements. An international examiner must obtain such agreements, related correspondence, and records. *See* I.R.M. 4.61.3.4.6, *Transfers of Intangibles*

The quality and reliability of each multinational corporate group's transfer pricing documentation varies widely. For example, the multinational corporate group's documentation usually leans toward assisting tax compliance. This practice often weakens the quality and reliability of transfer pricing documentation. Therefore, once multinational companies experience transfer pricing audits, they have an incentive to modify their documentation practices when they witness the problems created by compromised documentation. The United States found that most multinational companies provided satisfactory documentation in 2000–01, with a trend toward improved compliance.[75] In the United States, Sarbanes-Oxley's[76] new internal control requirements have led to improved reliability by requiring a demonstration to external auditors of actual compliance.[77] As a result, the auditors' report on internal controls has created a "new world" for examining transfer pricing documentation since 2005.[78]

Although the quality of documentation produced by "small to medium enterprises" (SMEs) is often low,[79] some governments have recognized that the standard is nevertheless an excessive burden—even when the multinational company receives third party

(Jan. 1, 2002), at 9, *available at* http://www.irs.gov/irm/part4/ch46s03.html#d0e442076.

[75] *See* IRS Dir. of Large and Mid-Size Bus. Div., *Fiscal Years 2000-01 I.R.S. Study: Effectiveness of Internal Revenue Code Section 6662(e)* (Dec. 28, 2001) (response to the request from the U.S. Senate Committee on Appropriations, 106th Congress, 1st Session).

[76] Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, 15 U.S.C. § 7262 (Supp. 2004).

[77] A company must identify its transfer pricing policies and provide external auditors with evidence of actual compliance with those policies. If the auditor is unable to recognize and certify compliance with the multinational company's policies, the U.S. multinational company may have to postpone filing its annual report with the U.S. Securities and Exchange Commission. Such an action usually shakes investor confidence in a multinational corporate group. *See* Molly Moses, *Large Multinationals Taking Steps to Ensure Pricing Process Meets Requirements of Sarbanes-Oxley Act, Practitioners Say*, 13 TAX MGMT. TRANSFER PRICING REP. 1091 (Mar. 16, 2005) [hereinafter *Large Multinationals*].

[78] Clark Chandler, Speaker at NYU in Prof. David Rosenbloom's Transfer Pricing Class (Apr. 1, 2005).

[79] Grant Thorton, *Transfer Pricing*, ASIA PACIFIC TAX ADVISER § 2 (Jan. 2005), *available at* http://www.gtjapan.com/english/ps/newsletter/0526_apta.pdf.

assistance in its analysis.[80] In 2005, Australia, Canada, and Denmark each created a simplified approach to documentation for SMEs.[81] In Australia, SMEs must accurately identify and record cross-border transactions, select an arm's length method, and test the method to ensure an arm's length result. The testing might be as simple as a basic benchmarking study. The SME must also implement a review process before completing the required tax form or schedule for its tax return.[82] Other countries should also limit SME documentation requirements to a basic documentation standard.

Contemporaneous documentation by multinational companies is critical throughout the transfer pricing process. Governments need multinational companies to effectively provide sufficient transfer pricing documentation to audit companies. Failure to conduct appropriate analyses or to document transfer pricing policies could and should result in significant transfer pricing adjustments and related penalties. These costs should be transparent in either the company's financial statements or security filings with a government's securities regulator. The documentation requirements for SMEs, however, should not discourage worldwide business expansion merely because of expensive transfer pricing studies.

For complex technology licenses, multinational corporations should expect that more governments will require a clear diagram of the various licensing arrangements and property rights, and a summary of the royalty terms. Given that many multinational companies will engage in extensive cross-licensing and sub-licensing, advisers may wish to ensure that tax auditors do not have to struggle to determine the basic facts about a multinational company's assets and liabilities. Otherwise, multinational companies should expect tax auditors to take a more aggressive approach in making transfer pricing audit adjustments.

[80] The OECD has recognized the need for balance between costs and administrative burdens. OECD GUIDELINES, *supra* note 6, ¶ 5.28 (1996).

[81] Austl. Tax Office, International Transfer Pricing: A Simplified Approach to Documentation and Risk Assessment for Small to Medium Businesses (2005) (NAT 12032-03.2005) [hereinafter Simplified Approach]; CRA Info. Cir. 94-4R, APAs for Small Businesses (Mar. 18, 2005). *See Denmark: Parliament Passes Bill Creating Penalties, Information Document Requirements*, 14 TAX MGMT. TRANSFER PRICING REP. 52 (May 25, 2005).

[82] *See Denmark: Parliament Passes Bill Creating Penalties, Information Document Requirements*, *supra* note 80.

IV. EXPERIENCING TRANSFER PRICING AUDITS OF INTANGIBLES

An adviser in a multinational corporate group should perform periodic spot-checks to ensure that transfer pricing is proceeding according to plan. New personnel or business problems may have created changes that the transfer pricing method does not reflect.[83]

A. Justifiable Audit Triggers and Auditors' Extensive Pre-audit Activities

While most multinational companies will usually not disregard the law, some believe their business strategies may place them dangerously close to questionable areas that exploit legal loopholes.[84] The natural, but unfortunate, result is that governments require more detailed transfer pricing audits to ensure that multinational companies comply with a country's transfer pricing legal requirements and the spirit of its law.

Planners should be aware of the range of appropriate transfer pricing audit triggers scrutinized by various governments.[85] For example, the Canadian Customs and Revenue Agency aggressively investigates intra-group costs allocated among related entities based solely on revenues.[86] China primarily targets multinational

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[83] Davis, *supra* note 24, at 83.

[84] *See, e.g.*, Jim Killaly, Austl. Tax Office, Large Bus. and Int'l, *Transfer Pricing Compliance Issues and Insights in the Context of Global Profit Allocation* (Mar. 9, 2000) (unpublished paper presented at the Transnational Crime Conference on file with author).

[85] Audit triggers in Australia include sizeable interest-free loans, inappropriate payment of royalties, assumption of exchange risk without compensation, and Australian companies losing assets through restructuring. *See* Cubby Fox, *Taking Aim at Transfer Pricing*, May 2004 (PwC-Australia), http://www.pwc.com/extweb/manissue.nsf/docid/D165D9792A8536C8CA256CE7000936F5.

[86] Other audit triggers in Canada include: 1) inbound management services, priced at a cost plus mark-up or a royalty basis, 2) outbound management services that are priced at cost, and 3) product sales to related parties with pricing that differs from the amount charged to unrelated customers. *See* Gordon Denusik, *CCRA Transfer Pricing Disputes*, Inst. Of Chartered Acct. of B.C. (May 27, 2005), *available at* http://www.iac.bc.ca kb.php3?pageid=2328. Canadian business auditors have become increasingly skilled in identifying transfer pricing issues. The business auditors can refer the case to over 220 specialized transfer pricing auditors in Canada. Ron Holowka, *Early Stage Technology Tax Issues International Transfer Pricing*, OTTAWA BUS. J. (May 28, 2004).

companies with sustained losses,[87] marginally profitable/loss making companies, and fluctuating profits.[88] In New Zealand, audit triggers include commissionaire arrangements,[89] stock option recharges or schemes, and regional or head office charges.[90]

Many countries, including the United Kingdom, have identified the following transfer pricing audit triggers: complexity of transactions, significant monetary values, changes in the audited entity's taxable income, and the restructuring of multinational corporate group operations.[91] Losses over a number of years are also of particular concern, according to the U.K.'s HM Revenue & Customs.[92] Another trigger for further audit inquiry in the U.K. includes any changes in the multinational corporate group's arrangements that purport to reduce risk and lead to reduced profits attributed to the local multinational company.[93] Suspicious

[87] *See, e.g.*, Shu Wei, *New Transfer Pricing Developments in China*, DELOITTE TOUCHE TOHMATSU, July 2004, at 2, http://www.china.ahk.de/gic/biznews/law/Bulletin_CTN0304E.pdf (last visited Mar. 18, 2006) (citing China's Circular No. 70 (Guo Shui Fa No. 70) (June 7, 2004) (regarding transfer pricing enforcement)).

[88] For example, a distributor's loss or substantially reduced profits might arise because of a fee paid to a related company abroad for the license. *See China Tax/ Business News Flash: Who Will Be the Next Transfer Pricing Audit Targets?*, PRICEWATERHOUSECOOPERS, June 2004, http://www.pwccn.com/home/eng/chinatax_news_jun2004_tp.html.

[89] A commissionaire arrangement allows the commissionaire (often the local multinational company) to conduct business with the customer in its own name while the principal (often a related multinational company) maintains all inventory, operational, and sales risks. At year end, the local multinational company merely reports a commission based on sales volume for tax purposes. *See Challenges to Popular Tax Structures: Tough Audit Issues for US Multinationals,* MORGAN, LEWIS & BOCKIUS LLP MORGAN LEWIS ON GLOBAL TAX ISSUES, Nov. 2001, at 3, http://www.morganlewis.com/pubs/040C61CF-01AB-4B7F-A59AFB0FC9902E7B_Publication.pdf.

[90] *See* GLOBAL SURVEY, *supra* note 8, at 61 (New Zealand's Fiscal Authority Approach).

[91] *See id.* at 11, fig.3.

[92] In 2005, the U.K.'s Inland Revenue was consolidated with "HM Customs and Excise" and renamed "HM Revenue and Customs." *See* Commissioners for Revenue and Customs Act 2005 c. 11 (Apr. 7, 2005). Such continued losses might arise from a multinational corporate group policy. *See, e.g.*, *INTM 461150—Transfer Pricing: Case Selection—Particular Factors Influencing Case Selection—Losses Over a Number of Years*, HM REVENUE & CUSTOMS, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM461150.htm (last visited Mar. 18, 2006).

[93] *See INTM 461060—Transfer Pricing: Case Selection—The Scope and Degree of Transfer Pricing Problems*, HM REVENUE & CUSTOMS, *available at*

restructuring changes include full service distributors becoming commissionaires, license manufacturers becoming contract manufacturers, research and development expertise switching from a royalty basis to a contract basis, and the addition of cost sharing arrangements.[94]

The division of intangibles among a multinational corporate group is likely an improper transfer pricing tactic and a major potential audit issue. For example, the payment of significant management fees or royalties or payment for the use of intangibles[95] are common factors that raise concerns and increase the chances of audit case selection.[96] The U.K. instructs its tax agents "to review the full facts, use common sense, and exercise judgment taking into account how a third party would have acted before reaching any conclusion."[97] Similarly, the acquisition or sale of intangibles often raises governmental audit inquiries.[98]

A cross-border reorganization usually triggers a transfer pricing audit, especially if valuable intangibles exist. For example, in the United States,[99] cross-border reorganizations are not taxable[100]

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http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM461060.htm (last visited Mar. 18, 2006).

94 *UK Inland Revenue Cracks Down on Transfer Pricing Planning*, MCDERMOTT WILL & EMERY NEWSL. (Mar. 17, 2003), http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/068663cb-9fb9-46af-a8ab-de358a6dec4a.cfm.

95 *See, e.g.*, *INTM 461170—Transfer Pricing: Case Selection—Particular Factors Influencing Case Selection—Charging for the Use of Intellectual Property*, HM REVENUE & CUSTOMS, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM461170.htm (last visited Mar. 18, 2006).

96 Questions arising from large management and service fees include whether the multinational company has a capable management team, whether the fees are large enough to reduce the company's profits to negligible amounts, whether the fees are paid to a company in a tax haven, and whether the fees are new. *See INTM 461160—Transfer Pricing: Case Selection—Particular Factors Influencing Case Selection—Payment of Significant Management Fees or Royalties*, HM REVENUE & CUSTOMS, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM461160.htm (last visited Mar. 18, 2006).

97 *See INTM 464090—Transfer Pricing: Types of Transactions—Intangibles; Fragmentation*, HM REVENUE & CUSTOMS, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM464090.htm (last visited Mar. 18, 2006).

98 *Id.*

99 *See* Jeffrey L. Rubinger et al., *Holding Intangibles Offshore May Produce Tangible U.S. Tax Benefits*, 37 TAX NOTES INT'L 907 (2005).

100 Temp. Treas. Reg. § 1.368-2(b)(1) (2003). *See generally* Mark A. Silverman et al., *Proposed Regulations Would Permit Cross-Border "A" Reorganizations for the*

except to the extent of transferred intangibles.[101] If the transfer is to a related party, then the U.S. multinational company transferor is treated as receiving annual payments for the use of the intangibles. These payments should be commensurate with the income from the intangibles over their useful lives.[102]

In addition, tax auditors usually spend an extensive amount of time examining the facts of a transfer pricing case, especially before contacting the taxpayer. Tax auditors in the U.K. have instructions to review information from many sources including internet searches, multinational corporate group websites, and commercial databases.[103] The auditors must make a risk assessment about a multinational corporate group's transfer prices.[104]

In preparing for a transfer pricing audit, government auditors should follow three general guidelines. They should (1) use "pre-audit techniques," (2) gain an understanding of taxpayer's operations, and (3) review the balance sheets and income statements.[105] Pre-audit techniques entail the review of the

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First Time in 70 Years, http://taxprof.typepad.com/taxprof_blog/files/2005-8326-1.pdf (last visited Mar. 18, 2006).

[101] I.R.C. § 367(d) (2005). This provision does not apply to the transfer of foreign goodwill or going concern value. 26 C.F.R. § 1.367(d)-1T(b) (2005).

[102] Temp. Treas. Reg. § 1.367(d)-1T(c) (2005). If the transfer is to an unrelated party, the fictional gain is immediately taxable. Temp Treas. Reg. § 1.367(d)-1T(d) (2005). For discussion of the international transfer of the PwC trademark name and associated goodwill and its potential avoidance of I.R.C. § 367(d) (2005), see Lee A. Sheppard, *PwC's Transfer Pricing Case from Hell*, 96 TAX NOTES 327, 331 (2002).

[103] Other sources include press reports, trade magazines, the tax agency's international library, and other government departments. *See INTM 461230—Transfer Pricing: Case Selection—Risk Assessment: Review of Information from Other Sources*, HM REVENUE & CUSTOMS, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM461230.htm (last visited Mar. 18, 2006).

[104] *See, e.g.*, *INTM 461200—Transfer Pricing: Case Selection—Risk Assessment—Detailed Process*, HM REVENUE & CUSTOMS, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM461200.htm (last visited Mar. 3, 2005). The risk assessment should examine six years of financial statements, the company's website, its business, the multinational corporate group structure, the multinational company's activities as reported in the trade press, comparables identified in a search of commercial databases, any controlled foreign corporation's tax return, and various other items. *Id.*

[105] For a summary of more specific guidance and procedures for large and mid-sized business examinations, see MICHAEL I. SALTZMAN, I.R.S. PRACTICE AND PROCEDURE ¶ 8.15 (2d ed. 2002).

multinational company's tax return,[106] particularly the tax return forms or schedules for reporting related party transactions.[107] Auditors in the United States are expected to compute five financial ratios for the multinational company based on both tax and financial data.[108] They then compare the ratios for the multinational company to relevant standard industry ratios.[109]

To obtain an understanding of a multinational company's business operations, the U.S. Internal Revenue Manual (IRM) provides more detailed instructions than similar information provided in other countries.[110] Auditors often seek to understand a multinational company's intangibles through a review of U.S. and foreign patents, trademarks, and prosecution files, together with research of patent litigation involving the multinational corporate group and review of copyright registrations.[111] To understand the underlying business, auditors should further inquire whether a foreign affiliate multinational company has similar intangibles,

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[106] *See* I.R.M. 4.61.3.4.1, *Preaudit Techniques* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html#d0e442076 (last visited Mar. 18, 2006) (citing I.R.S. Forms 5471 (Information Return with Respect to a Foreign Owned Corporation) and 5472 (Information Return of a Foreign Owned Corporation)). *See also* I.R.S. Form 8865, *Schedule O (Transfer of Property to a Foreign Partnership) and Schedule P (Acquisitions, Disposition and Changes of Interests in a Foreign Partnership)*; I.R.S. Form 1120, *Schedule M-3*, revised for 2005, also provides a guide to auditors of corporate tax returns in reconciling net income with total assets shown for financial accounting statement purposes.

[107] *See* DELOITTE TOUCHE TOHMATSU, *supra* note 57, at 16–17 (tax return disclosure requirements exist in Argentina, Australia, Brazil, Canada, China, Colombia, Denmark, Ecuador, India, Israel, Italy, Japan, Korea, Malaysia, Mexico, the Netherlands, Peru, Poland, Portugal, Singapore, South Africa, Taiwan, Thailand, the U.K., the U.S., and Venezuela).

[108] *See* I.R.M. 4.61.3.4.1 (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html#d0e442076. The five ratios are: 1) gross profit to net sales, 2) net profit to net sales, 3) operating expenses to net sales, 4) gross profit to operating expenses [Berry ratio], and 5) operating profit to average total sales.

[109] *Id*. For a list of references providing sources for more information on business comparisons and standard industry ratios, see The Library of Congress Business Reference Services, *A Guide to Finding Business Information at the Library of Congress* (June 20, 2005), http://www.loc.gov/rr/business/guide/guide1/guide1.html.

[110] Documents for the review of international agents include annual reports, SEC filings (especially Forms 10-K or 20-F), customs entry documents, sales catalogs, and other relevant documents. *Id*.

[111] I.R.M. 4.61.3.4.2(3), *Understanding the Taxpayer's Operations* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html#d0e442076.

whether technology transferred between the foreign affiliate multinational company and the U.S. multinational company, whether a cost sharing agreement exists, and whether a foreign affiliate multinational company bought into any cost sharing agreement.[112]

In conducting a review of the multinational company's financial statements, particularly the balance sheets and income statements, the U.S. international examiner should obtain product line income statements from taxpayers engaged in controlled transactions.[113] The auditor will likewise examine the multinational company's financial statements over a multiple year period to see if business cycles or product life cycles provide an explanation.[114] The auditor must obtain various internally generated documents to help perform a functional analysis of the multinational company.[115] The auditor also needs information on foreign related entities, particularly their tax returns and bank records.[116] In the outbound situation, an auditor should understand the relationship with foreign affiliates in the multinational corporate group.[117]

Audits often require an increased amount of information from multinational companies. Recently in the United States, this burden has arisen partly because the IRS counsel becomes involved prior to the audit.[118] Moreover, document requests have become more

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[112] Auditors should also inquire who conducted the research and development, the nature of the research, whether the company used marketing intangibles to develop the product, who developed the marketing intangibles, and which members of the multinational corporate group advertised. *Id*. at (7).

[113] I.R.M. 4.61.3.4.3(2), *Reviewing Balance Sheets and Income* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html#d0e442076 (last visited Mar. 18, 2006).

[114] *Id*. at 4.61.3.4.3(4).

[115] *Id*. at 4.61.3.4.3(5) (examples of desired information include management reports, budgets, and audit reports).

[116] *Id*. at 4.61.3.4.3(6).

[117] I.R.M. 4.61.3.2(2), *Final IRC Section 482 Regulations* (Jan. 1, 2002), *available at* http://www.irs.gov/irm/part4/ch46s03.html#d0e441996. Desired knowledge includes a foreign affiliate's history and background, its formation, government benefits and incentives provided, its manufacturing facilities, personnel, products, transfers of intangibles, development of manufacturing intangibles, purchase of raw materials, and sales of finished products.

[118] Before taxpayers forward any documents to the government official, they should review them to: 1) verify all information is correct, 2) determine if the information is consistent with the unit's tax return, and 3) meticulously consider the effect of the information when given to the government tax auditors. *See* Howard Kuo,

formal and the audit includes more depositions of key employees and third parties.[119] If written documents do not support a risk allocation scheme, auditors will probably ignore them.[120] Some governments (e.g., Canada) will even collect confidential third party information in transfer pricing audits.[121]

It is important for multinational corporate group advisers to understand audit triggers and effectively advise their clients on how to minimize the probability of a transfer pricing audit and its related burdens. Understanding the extensive preparation of many government auditors enables a multinational company to better prepare for an appropriate response. Multinational companies should also encourage governments to train their auditors on transfer pricing issues while preventing overzealous auditors from harassing multinational companies.

B. Governments' Transfer Pricing Audits of Intangibles: Audit Practice and Appropriate Auditor Behavior

Because tax auditor guidance varies significantly from country to country,[122] this section describes several approaches to transfer pricing audits and highlights certain aspects of the audit process. Multinational companies operating in Asia are particularly concerned about transfer pricing audits in China and India.[123] In countries such as China and India, local tax authorities conduct transfer pricing tax audits based on principles established by the national government to the extent such principles exist.

Corporate Tax Management for Transfer Pricing Audits, http://www.pwc.com.vn/extweb/pwcpublications.nsf/4bd5f76b48e282738525662b00739e22/92893e9ce39d6de6ca256f77000da819/$FILE/Events%20and%20Trends%20Vol.%20171.pdf.

[119] Alan Winston Granwell & James E. Brown, *Coming Conflicts: Proposed U.S. Transfer Pricing Services Regulations and the Treatment of Intangibles*, IBFD—DERIVATIVES & FINANCIAL INSTRUMENTS (Sept./Oct. 2004), at 14 [hereinafter *Coming Conflicts*].

[120] 26 C.F.R. § 1.482-1(d)(3)(ii)(B)(2) (2005).

[121] *See* Martin Przysuski, *Canada Reaffirms Use of Third-Party Information for Transfer Pricing Audits*, 34 TAX NOTES INT'L 205 (2004).

[122] For example, on April 12, 2005, Germany's Federal Ministry of Finance issued a seventy-six page document providing extensive administrative principles on expected transfer pricing documentation. *See* Christian Ehlermann & Andreas Kowallik eds., *Worldwide: German Tax & Legal News*, DELOITTE NEWSL., Apr. 2005.

[123] *Transfer Pricing Presents Greatest Risk for Companies in Asia, PwC Survey Says*, 14 TAX MGMT. TRANSFER PRICING REP. 92 (June 8, 2005).

The transfer pricing audit in China is a two-step process: (1) the "desk audit" and (2) the field audit at the multinational company's premises.[124] The field audit occurs only if the desk audit finds insufficient support from the multinational company's documents of the company's position. Companies in China should receive at least three days advance notice before a field audit.[125]

During the field audit, the tax auditors usually question the Chinese partner in a joint venture about the multinational company's related-party transactions.[126] The tax auditors also try to obtain additional documents from the multinational company to facilitate their investigation.[127] If the tax auditors believe that the Chinese multinational company is losing money through overpayment to a foreign parent corporation multinational company, the Chinese multinational company must make a convincing business case explaining the unique reasons for the loss.[128]

Transfer pricing audits occur in India if related party transactions exceed 50 million rupees (slightly over US$1 million).[129] India's local "transfer pricing officer" (TPO) reviews the international transactions in an "on-desk audit."[130] India's TPO has the authority to request documents from the taxpayers' foreign affiliates.[131]

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[124] *China*, 13 TAX MGMT. TRANSFER PRICING REP. S-8 (Jan. 19, 2005).

[125] *Id.*

[126] AM. CHAMBER OF COM. CHINA, PRACTICAL GUIDE TO TRANSFER PRICING IN CHINA (2005) (information provided by Matthew Mui or Lynn Wang of PricewaterhouseCoopers' Beijing office).

[127] *See* Spencer Chong & Rhett Liu, *Transfer Pricing Investigation in China*, PRICEWATERHOUSECOOPERS PERSP. (Winter 2001), at 17.

[128] For example, if the actual loss is five percent, while other companies in the industry are making a profit between three to eight percent. The Chinese multinational company might argue that low capacity utilization cost two percent, manufacturing defects cost one percent, foreign exchange losses cost two percent, and special start up costs cost four percent so that in the absence of these extra factors, the multinational company would have made four percent. AM. CHAMBER OF COM. CHINA, *supra* note 125.

[129] *India*, 13 TAX MGMT. TRANSFER PRICING REP. S-11 (Jan. 19, 2005).

[130] *Id.* The "on-desk audit" is similar to the "office audit" in the United States where the revenue agent remains at the IRS location in contrast to a field audit where the revenue agent goes to the taxpayer's premises.

[131] *Id. See generally*, Samir Gandhi & Rakesh Alshi, *Transfer Pricing Audits in India: The First Year Experience*, 13 TAX MGMT. TRANSFER PRICING REP. 842 (Dec. 8, 2004).

The Australian Tax Office (ATO) also uses a two-step process for a transfer pricing audit. A "transfer pricing review" precedes any field audit action. The ATO's transfer pricing review analyzes the multinational company's documentation and interviews corporate officials.[132] In the transfer pricing review, the ATO ranks the quality of the taxpayer's transfer pricing process and documentation on a scale from one to five. A low score increases the likelihood of a transfer pricing audit.[133]

Often the guidelines for transfer pricing audits of intangibles are limited. For example, the U.K.'s HM Revenue and Customs lists four basic audit issues for intangibles. The revenue agent must (1) identify any intangibles, (2) determine precisely who owns them, (3) judge whether they have value at arm's length, and (4) acquire expert assistance to pinpoint their value.[134] Consequently, marketing intangibles beyond brand names are always open to question in the U.K.[135]

Comparatively speaking, the United States provides the most detailed and extensive transfer pricing audit instructions. U.S. international examiners must complete a functional checklist for the different activities performed.[136] Examiners must also obtain expert assistance in economic analysis, which usually results in a stronger, more efficiently developed case.[137]

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[132] Simplified Approach, *supra* note 81, at 7.

[133] *Id.* at 14. Weak documentation also lengthens the probable audit process, requiring auditors to remain at the taxpayer's facilities longer and potentially hampering the multinational company's daily operations. *See* GLOBAL SURVEY, *supra* note 8, at Brazil's Fiscal Authority Approach.

[134] *INTM464070—Transfer Pricing: Types of Transaction: Intangibles: What are Intangibles?*, HM REVENUE & CUSTOMS, http://www.hmrc.gov.uk/manuals/intmanual/INTM464070.htm (last visited Mar. 18, 2006).

[135] *Id.*

[136] I.R.M. § 4.61.3-3, *Presentation of Findings* (Jan. 1, 2002). Some of the findings might arise from the auditor's visit to specific locations, such as the taxpayer's marketing office, manufacturing plants, distribution centers and warehouses, research and development centers, and quality control locations. I.R.M. § 4.61.3(1), *On-Site Visitations* (Jan. 1, 2002). Auditors conduct such visits to develop a better understanding of the taxpayer's marketing and advertising functions, the taxpayer's foreign affiliates, the development and exploitation of the intangibles, and the degree of the parent company's support. *Id.* at 3(2).

[137] I.R.M. § 4.61.3.3, *Economic Assistance* (Jan. 1, 2002).

Increasingly, teams of specialists conduct audits, as in China,[138] Belgium,[139] and Portugal.[140] An audit team generally includes an expert in international tax law, often an attorney or accountant. An economist selects comparables, determines arm's length transfer prices, and values intangibles. A computer audit specialist assists in analyzing data from the multinational corporate group.[141] An audit team might also have an industry specialist.[142]

Transfer pricing auditors should propose audit adjustments only where the multinational company deviated substantially from the arm's length method. However, inappropriate audit adjustments often occur,[143] including *de minimus* transfer pricing audit adjustments.[144] Another type of inappropriate adjustment tactic is using the threat of an adjustment as a "bargaining chip" that is negotiated away in exchange for settlements on more meritorious issues.[145] It is likewise inappropriate when auditors require proof that the local multinational company actually uses the licensed intangibles,[146] or when auditors move straight to proposing a profit

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[138] *See* PricewaterhouseCoopers, *Revised Transfer Pricing Regulations: More Strengthened and Centralized Transfer Pricing Enforcement in China* (Feb. 2005), http://www.pwccn.com/home/printeng/tp_cn_circular143_feb2005.html.

[139] *See* Dirk Van Stappen, *Belgium's Transfer Pricing Provision*, 14 TAX MGMT. TRANSFER PRICING REP. 38 (May 11, 2005).

[140] *See* Laurie Wiggins et al., *A Portuguese Perspective on Transfer Pricing*, 14 TAX MGMT. TRANSFER PRICING REP. 33 (May 11, 2005).

[141] William E. Bonano, *Transfer Pricing Examinations*, PILLSBURY WINTHROP & SUTRO LLP INT'L TAX BULL. (Feb. 1996).

[142] In Spain, industry specialists are considered the most qualified to challenge a taxpayer's transfer pricing. *See* GLOBAL SURVEY, *supra* note 8, at 65. In the U.S., the transfer pricing audit specialist might come from the "Industry Issue Resolution" program. *See* I.R.S. Notice 2000-65, 2000-52 I.R.B. 1.

[143] For example, the I.R.S. Appeals Office "sustention rate," the rate of agreeing with the revenue agent's decisions made in Section 482 cases, was only thirty-four percent in 1998. *See* I.R.S., REPORT ON THE APPLICATION AND ADMINISTRATION OF SECTION 482 apps. A-C (Apr. 29,1999), *available at* http://www.irs.gov/pub/irs-pdf/p3218.pdf (last visited Mar. 18, 2006) [hereinafter REPORT SEC 482].

[144] I.R.M. § 4.61.3.1(2), *Development of IRC Section 482 Cases* (Jan. 1, 2002).

[145] *Transfer Pricing: Alternative Practical Strategies*, 890-1st BNA TAX MGMT. FOREIGN INCOME PORTFOLIO (2005).

[146] *See* Robert J. Cunningham, *The Future of International Transfer Pricing: Practical and Policy Opportunities Unique to Intellectual Property Foreign Transfer Pricing Audits of Intangibles*, 10 GEO. MASON L. REV. 697 (2001–02) (this proof requirement occurs outside of the United States).

split approach rather than considering the multinational company's transfer pricing approach.[147]

Multinational companies should also prepare for possible transfer pricing audit negotiations for individual intangibles. A common audit concern arises when related parties pay royalties to each other when it is doubtful that the underlying intangibles are valuable.[148] Indirect indicators can help determine an appropriate share of revenues from the intangible. These indicators include the significance of the individual intangible within the intangible basket or technology license, innovation from the intangible, the age of the intangible, and restrictions on the intangibles.[149] Multinational company representatives must be prepared to articulate persuasively the economic justification for the royalty amount.

In the United States, multinational companies may request government audits of specific issues involving factual determinations or the application of well-settled law to the facts.[150] The IRS now offers a joint audit planning process that enables companies to work with IRS specialists in the transfer pricing audit. Usually the focus is on procedural issues that can help shorten the audit cycle and benefit both the multinational company and the government. These issues include setting appropriate timelines for information document requests, sharing risk analysis, and reaching materiality agreements.[151] When appropriate, an adviser outside the United States might also suggest a joint audit planning process

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[147] *See* OECD, *Contribution Received from PriceWaterhouseCoopers*, 2, as part of Transfer Pricing: The OECD Launches an Invitation to Comment on Comparability Issues. *See also* Ken Okawara & Masanori Kawanobe, *Japan Announces Results of Transfer Pricing Audits*, 20 TAX NOTES INT'L 245 (2000) (regional tax bureaus have often used the profit split method arguing there is no reasonable data available to apply).

[148] *See INTM 464100—Transfer Pricing: Types of Transaction—Intangibles: Royalties*, HM REVENUE & CUSTOMS, *available at* http://www.inlandrevenue.gov.uk/manuals/intmanual/INTM464100.htm (last visited Mar. 18, 2006).

[149] Other indicators include the type of competitive market impacting each intangible, the selling price erosion since the introduction of competitive products to the market, and the marketing developments for the intangibles. *Cf.* Contribution Received from BIAC [Business Industry Advisory Committee to OECD] 4, *Transfer Pricing: The OECD Launches an Invitation to Comment on Comparability Issues*, *available at* http://www.oecd.org/dataoecd/63/2/14554553.pdf (last visited Mar. 11, 2006).

[150] Rev. Proc. 2005-12, 2005-2 I.R.B. 311.

[151] *Coming Conflicts*, *supra* note 119, at 15.

during which the government will also audit the local multinational company within a reasonable period.

Although countries may simultaneously conduct international transfer pricing audits,[152] historically, few simultaneous audits have arisen given the challenges of coordinating each country's audit cycles.[153] As a result, government tax agencies instead choose to share company and industry information extensively.[154] As standard auditing processes develop around the world, multinational companies should also consider sharing more information within the multinational corporate group about appropriate policies, responses, and defenses for any transfer pricing audit process.

Worldwide, almost one-third of the transfer pricing audits generate a penalty.[155] Mistakes in financial information or documentation[156] may trigger such adjustments and penalties.[157] Thirty-seven countries charge penalties for transfer pricing abuses,[158] and in many of them (such as Mexico,[159] Kazakhstan,[160]

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[152] *See* CYM H. LOWELL ET AL., US INT'L TRANSFER PRICING ¶ 11.03[2][e], (2005).

[153] OECD GUIDELINES, *supra* note 6, ¶ 4.78–4.93. In 1999, the United States had twelve working arrangements for simultaneous exams with the following countries: Australia, Canada, France, Germany, Italy, Japan, Korea, Mexico, Norway, the Philippines, Sweden, and the U.K. *See* REPORT SEC 482, *supra* note 143, at app. A.

[154] Further sharing of information among governments is expected with the draft 2005 update to the OECD MODEL TAX CONVENTION ON THE TAXATION OF INCOME AND CAPITAL (2005), *available at* http://www.oecd.org/dataoecd/54/24/34576874.pdf (last visited Mar. 18, 2006). For example, article 26(1) represents the change to allow information sharing when "foreseeably relevant."

[155] *See* GLOBAL SURVEY, *supra* note 8, at 16.

[156] *Vigorous Enforcement Expected in Latin America in 2005*, 13 TAX MGMT. TRANSFER PRICING REP. 759 (2004).

[157] Some countries might refer to "interest" as a penalty while other countries impose a separate interest charge. Interest attempts to recover the real time value of money. *See* OECD GUIDELINES, *supra* note 6, ¶ 4.22. (1995). A penalty system, on the other hand, attempts to promote compliance. *Id.* ¶ 4.26. Rather than imposing penalties, Germany's approach to the transfer pricing audit adjustment is to set the transfer price at the high end of the acceptable range.

[158] *See* DELOITTE TOUCHE TOHMATSU, *supra* note 57, at 14–15.

[159] *See* Albertina M. Fernandez, *Tax Reform Gains Momentum in Latin America*, 16 TAX NOTES INT'L 1050 (Apr. 6, 1998) (US$250 million in Mexico).

[160] *See Kazakhstan: Canadian Oil Concern's Kazah Subsidiaries Receive $76 Million Assessment for 2002–2003*, 14 TAX MGMT. TRANSFER PRICING REP. 11 (May 11, 2005).

and Japan[161]), transfer pricing audits have increased revenues for their governments.

Some countries have enacted a penalty structure resembling the U.S. penalty regime for valuation misstatements.[162] The U.S. penalty structure recognizes that transfer pricing is as much an art as a science; therefore it grants wide latitude in determining transfer pricing.[163] To determine if a penalty applies, governments typically require that companies report related party transactions on their income tax return.[164] Often, countries provide a narrow exception to transfer pricing penalties,[165] usually based on reasonableness.[166] Multinational companies should lobby governments to increase the flexibility of transfer pricing penalties. Reviewing authorities in the government should have the power to

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161 *See also* GLOBAL SURVEY, *supra* note 8, at 53 (transfer pricing adjustments in 2001 amounted to a total of 85.7 billion yen).

162 For example, Australia imposes a twenty-five percent penalty for other transfer pricing arrangements having a tax avoidance purpose and a fifty percent penalty for transfer pricing having the sole purpose of tax avoidance. However, these penalties receive respective reductions of ten percent or twenty-five percent if the multinational company has a reasonably arguable position. *See* TR 98/16, *Income Tax: International Transfer Pricing–Penalty Tax Guidelines* (Austl), *available at* http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR9816/NAT/ATO/00001 (last visited Mar. 11, 2006).

163 In the United States, a twenty percent valuation misstatement penalty applies if *either* a transfer price claimed on any tax return is 200% or more (or 50% or less) of the correct median transfer price determined under section 482 *or* the net section 482 transfer price adjustment for a year exceeds US$10 million. I.R.C. § 6664(e)(1)(B) (2005). The penalty doubles to forty percent in the case of a gross valuation misstatement if *either* the price claimed is 400% or more (or 25% or less) of the correct amount *or* the net section 482 adjustment exceeds US$20 million. I.R.C. § 6664(h) (2005).

164 For instance, the Canada Revenue Agency may use Form T106 as a screening tool. *See* Kevin Bell, *Response on Tax Form May Trigger Transfer Pricing Audit in Canada*, 34 TAX NOTES INT'L 806 (2004).

165 DELOITTE TOUCHE TOHMATSU, *supra* note 57, at 16–17 (countries offering a potential reduction in penalties are Australia, Belgium, Brazil, Canada, Colombia, The Czech Republic, Germany, India, Korea, Malaysia, Mexico, the Netherlands, New Zealand, Peru, Portugal, South Africa, Thailand, the U.K., the U.S., and Venezuela).

166 In Australia, "penalties may be reduced if a taxpayer has a 'reasonably arguable position' in relation to the transfer pricing adjustment." *See* Philip Anderson, *PATA Transfer Pricing Documentation Package*, ASIA-PAC. TAX BULL. 199, 201 § 4.2.1 (2003) (citing Australian Income Tax Assessment Act 1936 § 222C (1936)). Canada requires "reasonable efforts to determine and use arm's length transfer prices." Canada Revenue Agency, Canadian Circular 87-2R International Transfer Pricing ¶ 179 (1999). In the U.S., a "reasonable cause" and "good faith" exception exists to the penalties. 26 U.S.C. § 6664(c) (2000); 26 C.F.R. § 1.6662-5(j)(5)(a) (2005).

reduce a penalty if they accept a multinational company's defense against perceived tax avoidance.

Multinational companies should also seek to reduce government tax audits by regularly performing internal audits of their subsidiaries to assess and correct any deficiencies. Multinational companies need to assess the ethical culture in their countries of operation to determine the extent to which they can rely on representations from the local multinational company.[167] In the course of an audit, representatives can encourage diplomacy in the local affiliate's response to government tax auditors—and exemplify it themselves—by asking questions in the context of civil conversation and limiting criticism to the audit rather than the auditor.[168]

Multinational companies sometimes want the "competent authority" of two governments to agree on a tax issue under audit. For example, the multinational company may request help from the "mutual agreement procedure" in a bilateral tax treaty to prevent double taxation.[169] Through this approach, when one country makes a transfer pricing adjustment, the multinational company receives a correlative adjustment in the other country.[170]

As global transfer pricing audits become increasingly sophisticated, the audit of intangibles requires the transfer pricing audit team to use commercial judgment and valuation expertise. To perform this role effectively, multinational companies should encourage more governments to use professional teams of transfer pricing auditors with legal, accounting, and economic expertise.

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[167] Accounting firms have international exchange programs, partly to acquire an outside perspective on local multinational companies. An exchange helps to determine who makes the most reliable assessments rather than just presenting information that the outsider might like to hear. Author's private discussion with PwC tax partner at the 2005 PwC University for Faculty in New Jersey (June 16, 2004).

[168] *See generally* Margaret Kent & Robert Feinschreiber, *Contra-Audit Transfer Pricing Strategies*, 17 TAX NOTES INT'L 1737 (Nov. 30, 1998).

[169] For a discussion of proposed changes to the "mutual agreement procedure," see *Draft OECD Report on Competent Authority Issues, Possible Changes*, 13 TAX MGMT. TRANSFER PRICING REP. 423 (2004).

[170] The I.R.S. offers a simultaneous Appeals/Competent Authority procedure under a tax treaty. *See* Rev Proc. 96-13, 1996-1 C.B. 616. In the United States, a taxpayer should file protective claims for refund if it expects a correlative adjustment from a transfer pricing settlement because any correlative adjustment affects the taxpayer's income on a year to year basis. *See* Field Serv. Adv. TL-N-1354-01 (2001).

Transfer pricing audits are necessary to prevent multinational companies from engaging in inappropriate tax avoidance; however, the transfer pricing auditors should give broad leeway to the multinational company's careful assessment of transfer prices. Multinational companies should not hesitate to remind auditors that their audit approach affects the multinational company's investment decisions and the corresponding intellectual property expansion in the country.

V. RESOLUTION OF TRANSFER PRICING AUDITS ON INTANGIBLES

Because government audit decisions affect company policy, forward-thinking companies value expeditious resolutions of audit issues. Sometimes the multinational corporate group or local company brings in additional outside advisers to help resolve any transfer pricing issues arising from the audit. However, a better strategy is to consider resolving probable transfer pricing issues in advance through agreement with the government, widely known as an Advance Pricing Agreement.

A. Administrative Resolution, Especially with Advance Pricing Agreements (APAs)

Constructive resolution of transfer pricing audits usually requires the government tax authority and the multinational company to agree on both the facts and a set of applicable transfer pricing practices.[171] Because efficiency is vital, optimal operations occur when both the multinational company and the government avoid inflexible positions. They should maintain open and frank dialogue, consider alternative ways to characterize the transactions, and remain flexible to resolve any differences.[172] A government and a multinational company usually settle over ninety percent of cases prior to litigation,[173] including transfer pricing audit cases.[174]

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[171] *See* Cym Lowell & Peter L. Briger, *Adequacy of International Dispute Resolution Mechanisms*, 10 GEO. MASON L. REV. 725, 733 (2002).

[172] *Id.*

[173] Delegation Orders 236-237 *cited in* SALTZMAN, *supra* note 105, ¶ 8.15[6][a].

[174] Khaled M. Diaw, *Ownership Restrictions, Tax Competition and Transfer Pricing Policy*, June 23, 2004, at 2 (according to claims by tax reform advocates at Senate Committee hearings in 1993).

Various methods generally exist for settling a tax dispute. Frequently, an administrative appeals review board within the government accomplishes settlements.[175] Settlements may include accelerated issue resolution through consideration, mediation, or arbitration.[176] For example, the European Arbitration Convention has helped settle transfer pricing disputes within the European Union (E.U.).[177] To harmonize governments' approach to applying the Arbitration Convention, the E.U. has adopted a "Code of Conduct on Transfer Pricing."[178] An administrative approach to settlement is more informal than litigation, which promotes frank discussion and mutual understanding.[179] The favorite type of

[175] Usually, an administrative appeals board does not publish their decisions. However, an exception exists in India. In a multinational corporate group case involving a French parent company and an Indian subsidiary that produced medical instruments, the Indian tax authority held that an interest-free loan was subject to transfer pricing coverage. *See* A.A.R. No. 609 (2003), *Indian Advance Ruling Authority Decision on Applying Transfer Pricing Laws* (New Delhi) (Nov. 24, 2004), *reprinted in* 13 TAX MGMT. TRANSFER PRICING REP. 967 (Feb. 2, 2005), *cited in India: Ruling Board Says Transfer Pricing Laws Apply Even if Compliance Lowers Tax Liability*, 13 TAX MGMT. TRANSFER PRICING REP. 958 (Feb. 2, 2005). The Indian multinational company failed with its valid argument. The Indian Ruling Board held that the nondiscrimination provision of the Finland-India tax treaty could still apply transfer pricing concerns that did not apply to domestic related party transactions. Arguably, the ruling may have been necessary to increase the compliance for transfer pricing in India.

[176] *See* I.R.M. 35.3.20, *Mediation* (Jan. 24, 1996); I.R.M. 35.3.20.1 *Preliminary Considerations* (Jan. 24, 1996). *See also*, ROBERT T. COLE, *Arbitration of Transfer Pricing Disputes Under Tax Court Rule 124*, *in* PRACTICAL GUIDE TO U.S. TRANSFER PRICING 23.15 (2d ed. 2001). The U.S. Senate Finance Committee is expected to recommend arbitration when the IRS misses meeting case management timelines or when negotiations with foreign governments becomes unprincipled or inconsistent. *See Finance Committee Draft Report Suggests JCT Review, Looking to 'Bottom Line' in APAs*, 14 TAX MGMT. TRANSFER PRICING REP. 154 (June 22, 2005).

[177] Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, July 23, 1990, 90/463/EEC, 1990 O.J. 225/10 (L 225) (EC). [hereinafter European Arbitration Convention]. *See generally* Gianmarco Monellato, *France and Italy Settle First Case under Arbitration Convention*, TAX PLANNING INT'L TRANSFER PRICING (July 2003) (regarding "profit allocation between a manufacturer and a distributor").

[178] The E.U.'s Council of Finance Ministers adopted the Code. Proposal for a code of conduct on transfer pricing documentation for associated enterprises in the E.U. COM (2005) 0543 final (Nov. 7, 2005), *available at* http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:52005PC0543:EN:HTML. *See also Company Taxation: Commission Proposes Code of Conduct to Eliminate Double Taxation in Cross-Border Transfer Pricing Cases* IP/04/542 (Apr. 27, 2004).

[179] I.R.M. 8.6.1.2, *Appeals Conferences* (Feb. 18, 1999).

settlement in the United States is the "Mutual Concession Settlement" in which neither party concedes the underlying issue.[180] If the relative values of the issues in an all-or-nothing situation are similar, parties may trade issues to reach a "Split Issue Settlement."[181]

A company may also enter into an Advance Pricing Agreement (APA) with a government to preempt disputes by securing pre-clearance on the multinational company's transfer pricing. The APA determines the appropriate transfer pricing method, comparables, adjustments, and critical assumptions for the APA's future duration.[182] APAs for intangibles usually cover a "bundle of commercial property that when combined, form an entire business system."[183] In theory the APA represents a voluntary, binding contract between a government and a multinational company,[184] usually made after extensive pre-filing discussions[185] (A government's APA team[186] must conduct due diligence to establish that the facts submitted by the multinational company are complete and accurate.[187]). In reality, however, governments sometimes force

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[180] I.R.M. 8.6.1.3.1, *Mutual Concession Settlements* (Feb. 18, 2003).

[181] I.R.M. 8.6.1.3.2, *Split Issue Settlements* (Dec. 15, 2004) (settlements of penalty issues must be based on the merits and hazards of litigation surrounding each penalty).

[182] OECD GUIDELINES, *supra* note 6, at G-1 (Glossary) (1996). *See, e.g.*, Robert Weissler, *Memorandum for APA Economists*, *in* ADVANCE PRICING AGREEMENT PROGRAM TRAINING MANUALS, *reprinted in* 10 TAX MGMT. TRANSFER PRICING REP. (July 5, 2000).

[183] Austl. Tax Office, *Advance Pricing Arrangement Program: Report of Developments in 2003-04* (Oct. 2004) [NAT 12082], *available at* http://www.ato.gov.au/print.asp?doc=/content/50911.htm. This bundle of intangibles can encompass "knowledge/know-how, business and IT systems, processes and procedures, specifications, trademarks, trade names and branding. Some elements may be protected by trademark and copyright and others by confidentiality agreements." *Id.*

[184] *Id.* at ann. 2004-26.

[185] *See, e.g.*, Ernst & Young, *New Developments in Dutch APA/ATR Practice*, Apr. 23, 2003. The Dutch planned to formalize pre-filing meetings to discuss facts and different options prior to the multinational company filing of the APA request. *Id.*

[186] The APA team is similar to an audit team. A team leader coordinates contact with the multinational company. Team members are usually comprised of an international examiner, an economist, a lawyer, and perhaps other specialists (industry, tax treaty, or appeals officer). *See* I.R.S. Ann. 2004-26, 2004-15 I.R.B. 743 (Apr. 12, 2004) (5th Annual APA Report in the U.S.).

[187] *See id.* at ann. 2004-26.

companies into APAs.[188] Another frustration is that not all companies seeking an APA or its renewal are accepted.[189]

Despite some shortcomings, APAs offer a number of advantages to companies.[190] Notably, many companies primarily enter into an APA to acquire tax certainty rather than tax savings.[191] Tax certainty is often essential to effectively implement other international tax planning strategies.[192] With an APA, the multinational company should have certainty for the APA's duration, usually about five years.[193] An APA can also substantially reduce the probability of costly transfer pricing audits and litigation.[194]

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[188] *See, e.g.*, *Wal-Mart Stores, Inc, Before the I.R.S., APA Public Hearing* (Feb. 22, 2005) (statement of Wyman Atwell), *available at* http://www.irs.gov/pub/irs-apa/wal-mart_stores_-_wyman_atwell.pdf (last visited Mar. 18, 2006). About one-third of U.S. companies entered into an APA during an audit. Sean Foley, Principal KPMG, Comments at NYU Prof. H. David Rosenbloom's Transfer Pricing Class (Apr. 8, 2005).

[189] Canada has discontinued APAs with about thirteen percent of companies. The companies sometimes withdrew from the APA program or had their applications revoked by the Canadian authorities. *Global Transfer Pricing Update*, 31 TAX NOTES INT'L 327 (July 28, 2003).

[190] *See e.g.*, Austl. Tax Office, *Introduction to Concepts and Risk Assessment* (Apr. 2005), at 3 [NAT 2725], *available at* http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/35283.htm (last visited Mar. 4, 2006) (explaining that benefits include reducing the possibility of double taxation, reducing record keeping burdens, and reducing business costs).

[191] *See* Kevin A. Bell, *U.S. Senate Panel to Review APA Program*, 33 TAX NOTES INT'L 232, 232 (2004) (quoting Chris Faiferlick of Ernst & Young).

[192] Judith P. Zelisko on behalf of Tax Executives Institute, *The I.R.S.' Advance Pricing Agreement Program*, IRS Hearing, Feb. 22, 2005 [hereinafter IRS hearings]. In addition, some taxpayers view APAs as having restrained potential transfer pricing excesses of several countries. *See* Henry J. Birnkrant & Robert T. Cole, *Remarks of Henry J. Birnkrant & Robert T. Cole, of Alston & Bird LLP on Advance Pricing Agreements*, IRS Hearing, Feb. 22, 2006, *available at* http://www.irs.gov/pub/irs-apa/alston_and_bird_-_henry_birnkrant _ and_robert_cole.pdf.

[193] Slightly more than half of the APAs had five year terms and one-third had a term longer than five years. I.R.S. Ann. 2005-27 (Mar. 31, 2005).

[194] *See, e.g.*, *Advance Pricing Agreements: Costco Resolves Dispute with Canada, U.S. Over Royalty Due U.S. Parent for 1996-2006*, 13 TAX MGMT. TRANSFER PRICING REP. 1093 (Mar. 16, 2005). The Costco APA covered intangibles, including know-how and trademarks. The SEC Form 8-K filing said net income was positively impacted by a one-time US$52 million income tax benefit resulting primarily from settlement of a transfer pricing dispute between the United States and Canada. *Id.*

APAs may be unilateral, bilateral, or multilateral.[195] A unilateral APA is the most common type[196] and only involves the multinational company and the government.[197] A multinational company might prefer a unilateral APA when there is a concern that the request for an APA in another country might trigger an audit there.[198]

A bilateral APA is an increasingly popular solution[199] that involves two governments negotiating to create a uniform standard that each will apply to the multinational corporate group.[200] Governments sometimes prefer bilateral APAs[201] because they can have persuasive effect beyond the countries involved and influence government policies in third countries.[202]

In a multilateral APA, several countries jointly define how a multinational corporate group should set its transfer prices in those

[195] The IRS released updated guidance on APAs in Rev. Proc. 2004-40, 2004-29 I.R.B. 1. For APA procedures in China, see China's Circular No. 118 (Guo Shui Fa No. 118) (Sept. 3, 2004). For APA procedures in other countries, see BNA, *Transfer Pricing European Rules and Practices* (France, U.K., and Germany), 895 TAX MGMT.; BNA, *Transfer Pricing: Foreign Rules and Practices Outside of Europe, Part I* (Canada, Mexico, and Japan), 897 TAX MGMT.; and BNA, *Transfer Pricing: Foreign Rules and Practices Outside of Europe, Part II* (Korea, Australia, and Brazil), 898 TAX MGMT.

[196] *See* Steven S. Saeger et al., *Comment on PATA Guidance for Bilateral APAs*, ITPJ (Jan./Feb. 2005), at 3–6.

[197] *See, e.g.*, Landwell & Associates [trans.], *French Finance Ministry's Unilateral APA Guidelines*, 14 TAX MGMT. TRANSFER PRICING REP. 191 (July 6, 2005) (reporting Administrative Reg. A4 A-11-05, issued June 24, 2005).

[198] Sean Foley, Principal KPMG, Comments at NYU Transfer Pricing Class (Apr. 8, 2005).

[199] *See, e.g.*, *Dutch Ministry Handling More A.P.A. Requests, Processing Fewer Unilateral, 'Other' Requests*, 13 TAX MGMT. TRANSFER PRICING REP. 1100 (Mar. 16, 2005).

[200] For example, in 2003–04, Australia completed eight bilateral APAs involving Canada, the U.S., Japan, the Netherlands, and New Zealand. ATO, APA REPORT (NAT 12082-10.2004) (fig. 2 and accompanying text). In 2005, China and Japan entered into China's first bilateral APA. *China's First Bilateral APA Concluded*, 2005 TAX PLANNING INT'L TRANSFER PRICING.

[201] *See, e.g.*, U.K. TRANSFER PRICING GROUP, ERNST & YOUNG, U.K. TRANSFER PRICING GROUP, TRANSFER PRICING IN THE U.K. 15 (2004). Bilateral APA negotiations effectively resolve concerns about acquiring potential correlative adjustments by the other government tax authority. The multinational company seeking the APA contributes behind the scene to the discussion and negotiation between the relevant tax authorities of the two countries.

[202] Prof. H. David Rosenbloom, Comments at NYU Transfer Pricing Class (Apr. 8, 2005).

countries.[203] A multilateral APA is most appropriate where a corporation conducts global trading or has become a globally integrated business.[204] Multilateral APAs are a recent development[205] and are still rare.[206] However, multilateral APAs should increase dramatically, especially once the E.U. establishes coordinated transfer pricing procedures.

The United States[207] and Australia created the first APAs in 1991.[208] At least twenty-four other countries have since formally adopted them.[209] The APA procedures among countries are

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[203] *See, e.g.*, *Germany: Germany Aims to Streamline APA Process by Allowing Direct Negotiations with Berlin*, *13* TAX MGMT. TRANSFER PRICING REP. 57 (Sept. 29, 2004).

[204] For example, the first European multilateral APA was for Airbus, a leading European aircraft manufacturer. *See* Laurence Delorme et al., *Airbus APA: Using Multilateral Agreements to Solve Complex Transfer Pricing Issues*, 13 TAX MGMT. TRANSFER PRICING REP. 276 (July 21, 2004) (The multilateral APA was between France, Germany, Spain, and the U.K.).

[205] OECD GUIDELINES, *supra* note 6, Annex: Guidelines for Conducting APAs under the Mutual Agreement Procedure, at AN-28 (1999). The first two multilateral European APAs were signed in 2004. *See APAs Are Set to Take Off in Europe*, 2004 INT'L TAX REV. 37 (June 2004) [KPMG, available at kpmgbe.lcc.ch].

[206] Several countries have engaged in multilateral APAs. France has engaged in three multilateral APAs, all with E.U. countries. Michael Collet, Int'l Tax Inst. (3rd Annual) at Fordham Univ. (June 2, 2005) (paper and statement). As of the end of 2004, the United States has engaged in eight multilateral APAs. Rev. Proc. 2005-27, I.R.B. 2005-16 (Apr. 18, 2005). Japan has engaged in at least four multilateral APAs. Caplin & Drysdale, *International Tax: Negotiating Advance Pricing Agreements*, *available at* http://www.capdale.com/practices/areadescriptions.asp?ID=50 (last visited Mar. 21, 2006).

[207] The success of APAs in the United States arose in part because the U.S. APA Office is separate from the field office that conducts audits. This changes the dynamics for negotiation. Sean Foley, Principal KPMG, Comments at NYU Transfer Pricing Class (Apr. 8, 2005). The productivity of economists in evaluating cases illustrates the difference. The APA economists complete about one case per month while the transfer pricing audit economists complete one case every three months.

[208] *See* Simon Phillipson, *Australia Enters Multilateral Advance Pricing Agreement*, 2 J. INT'L TAX'N 116 (1991).

[209] Besides the United States and Australia, before 2001 APAs were authorized in Brazil (1997), Canada (1994), France (1999), Germany (2000), Japan (1987), Korea (1996), the Netherlands (1999), New Zealand (1994), and the U.K. (1999). *See Japan's Second Annual APA Report*, 13 TAX MGMT. TRANSFER PRICING REP. 587 (2004). Other countries authorizing APAs in more recent years include Belgium, China, Colombia, Hungary, Israel, Italy, Kazakhstan, Mexico, Peru, Portugal, Singapore, Spain, Taiwan, Thailand, and Venezuela. *See* DELOITTE TOUCHE TOHMATSU, *supra* note 57, at 28–29. Additionally, Austria, Indonesia, the

substantially similar, but they have some procedural differences.[210] Parties do not generally publish APAs, unless the multinational company publishes them pursuant to litigation.[211] However, public documents sometimes reveal basic information on APAs.[212] The United States was the first to introduce an annual government report on APAs.[213] Other countries who now issue an annual APA Report include Australia, Canada, and Belgium.[214] The APA Reports are informative, particularly in categorizing the actual approaches used in transfer pricing cases settled through an APA.[215]

Due to these benefits, the demand for APAs should increase. In the United States, strict compliance with the Sarbanes-Oxley Act is expected to motivate more multinational companies to enter into or renew APAs,[216] and once companies have obtained APAs, they usually desire to renew them. Some taxpayers with APAs would

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Netherlands, Sweden, and Switzerland have engaged in APAs. ERNST & YOUNG, TRANSFER PRICING GLOBAL REFERENCE GUIDE 8, 33, 41, 55, 56 (May 2005).

[210] *See, e.g.*, Steven C. Wrappe et al., *Side-By-Side Comparison of the APA Procedures: The United States and Australia*, 38 TAX NOTES INT'L 821 (2005); Steven C. Wrappe et al., *Side-By-Side Comparison of the APA Procedures: The United States and France*, 37 TAX NOTES INT'L 1195 (2005); Steven C. Wrappe et al., *Side-By-Side Comparison of the APA Procedures: The United States and Japan*, 37 TAX NOTES INT'L 401 (2005). For an example of the development of the APA program, see Bruno Gibert, *Consolidating and Developing the French Advance Pricing Agreement Procedure*, EUR. TAX'N (Feb. 2005).

[211] An APA published in litigation is insightful for showing amounts allocated to intangibles for a pharmaceutical multinational company: twenty-eight percent of net trade sales as marketing commissions, five percent of net trade sales for the trademark, and three percent of net trade sales for the trade name. *IRS APA for Dyazide, Tagamet,* 13 TAX MGMT. TRANSFER PRICING REP. 922, app. A (Jan. 19, 2005).

[212] *See, e.g.*, *Advance Pricing Agreements: Costco Resolves Dispute with Canada, U.S. Over Royalty Due U.S. Parent for 1996-2006*, 13 TAX MGMT. TRANSFER PRICING REP. 1093 (Mar. 16, 2005) The Costco APA covered intangibles, including know-how and trademarks. Costco's SEC Form 8-K filing said net income was positively impacted by a one-time US$52 million income tax benefit resulting primarily from settlement of a transfer pricing dispute between the United States and Canada. *See* Costco Wholesale Corp., Form 8-K (May 26, 2005).

[213] *See, e.g.*, Rev. Proc. 2004-26, 2004-15 I.R.B. 743.

[214] *See Second Decade of APAs: Greater Transparency*, 11 TAX MGMT. TRANSFER PRICING REP. S-3 (Mar. 5, 2003).

[215] For example, in Canada a large number of APAs use a profit-split method when quality comparable transactions are not available. Canada Revenue Agency, *APA Program Report 2003–2004* 14, http://www.cra-arc.gc.ca/tax/nonresidents/business/apa_report04-e.html (last visited Feb. 24, 2005).

[216] *Large Multinationals*, *supra* note 77, at 1093.

like the United States to enter into "synthetic bilateral APAs" with countries like Argentina and Brazil that do not have tax treaties with the United States.[217] The APA process is not without its critics—it takes an average of over two years in the U.S.[218]—and some allege the APA process is broken.[219] In 2005, the U.S. Senate reviewed the U.S. APA program and will probably recommend that the IRS harmonize the system by placing a dollar figure on the transactions covered by each APA.[220]

APAs have great promise, but the system needs further refinements. Simplified procedures may encourage more small to medium-sized businesses to participate in an APA program.[221] Governments must continue to invest more resources in the APA process for both hiring personnel and training APA teams. In addition, APA teams need greater expertise in order to develop industry specializations in complex areas where multinational companies seek integration across countries.[222]

Companies should consider obtaining APAs. They are not panaceas; however, to resolve transfer pricing audits administratively, it is essential that the multinational corporate group have credibility with the relevant governments. APAs are only part of the process; the corporate group establishes credibility primarily through the sum of its actions, which consists of the quality of its transfer pricing documentation and its responsiveness to government inquiries.

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[217] *See* John Mitchell, Vice-President, Eaton Corp, *IRS APA Hearings*, Feb. 1, 2005, *available at* http://apps.irs.gov/pub/irs-apa/eaton.pdf.

[218] Similarly, taxpayers sometimes complain that APA renewal is more time consuming than needed. *See, e.g.*, Daniel Karen & Pat Breslin, *IRS APA Hearing Urges Fairness (and Funding) Over Consistency*, 6 TAX NEWS AND DEV. 13 (Feb. 2005).

[219] Peter Blessing, Int'l Tax Inst. (3rd Annual) at Fordham Univ. (June 3, 2005) (moderator of the New U.S.-Int'l Env.: Gov. Roundtable)

[220] *See* Lee Sheppard, *Draft Senate Finance APA Report Shows Incompetent IRS*, 2005 TAX NOTES TODAY 119-1 (June 22, 2005).

[221] *See* Notice 98-65, 1998-2 CB 803 (special APA procedures for small business in the U.S.); *cf.* Deloitte, *French Tax Administration Announces Measures to Improve APA Program*, THE ARM'S LENGTH STANDARD, 2 (Feb. 2005).

[222] The United States will create specialized APA teams in five areas (automotive, financial products, pharmaceuticals, semiconductors, and cost sharing). These five areas have consumed fifty-six percent of the total case time during the past two years. *See* Molly Moses, *Practitioners Hail Changes to APA Program Designed to Speed Cases, Increase Accountability*, 14 TAX MGMT. TRANSFER PRICING REP. 3 (May 11, 2005).

B. Litigation is a Risky Solution

In most countries, little or no transfer pricing case law exists,[223] especially regarding intangibles.[224] Even though companies who litigate over intangibles usually achieve partial success, litigation is risky for multinational companies. There is a lack of litigation partly because litigation on complex tax cases often takes over five years from the first year at issue.[225] Given that rigorous worldwide transfer pricing regulation has only occurred within the last decade, more cases are likely to arise in the future. [226] For instance, multinational companies operating in Canada are increasingly turning to Canadian courts.[227] Another possible reason for lack of case law on these issues may derive from the fact that governments usually litigate only those cases presenting broad compliance issues.

Internationally, most transfer pricing case law has failed to provide a relatively predictable rationale for the court's decisions.[228] In Russian courts, the government's transfer pricing arguments have continuously failed in court because the tax authorities lack either essential expertise, resources, or economic data to establish a market rate.[229] Transfer pricing in Russia has

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[223] *See Transfer Pricing Cases Around the World*, 12 TAX MGMT. TRANSFER PRICING REP. 970 (Mar. 3, 2004).

[224] Transfer pricing cases on intangibles have arisen in Belgium (No. 1997/FR/33) and Germany (6 K 1910/98). *Id.* In 2001, Korea's first transfer pricing case involved royalties paid to the U.S. parent. *See* Youngjin Jung, *First Korean Case on Transfer Pricing Comparability: Dubious Conclusions, Statistical Errors*, J. INT'L TAX'N (2004).

[225] *See, e.g.*, *Transfer Pricing Cases Filed in Argentina; First Lawsuit Expected Soon in Mexico*, 12 TAX MGMT. TRANSFER PRICING REP. 737 (2004).

[226] *Litigation: First Half of 2004 Shows Eightfold Increase in Allocations: Cases Filed Double from 2003*, 13 TAX MGMT. TRANSFER PRICING REP. 253 (Jul. 21, 2004).

[227] *See* Molly Moses, *As Negotiations Falter, U.S. Competent Authority 'Not Discouraging' Litigation in Canadian Courts*, 10 TAX MGMT. TRANSFER PRICING REP. 559 (Sept. 29, 2004). However, no Canadian cases have addressed inter-company transfer of intangibles. *See* Nathan Boidman, *Canada, Transfer Pricing: Foreign Rules and Practice Outside of Europe*, 897-1st BNA TAX MGMT. PORTFOLIO (in the text after note 105).

[228] Eduardo Baistrocchi, *The Arm's Length Standard in the 21st Century: A Proposal for Both Developed and Developing Countries*, TAX NOTES INT'L 241, 255 (Oct. 18, 2004).

[229] *See* Dmitry Rybko and Biaino Kutanina, *Russia Paying Close Attention to Transfer Pricing Rules*, 13 TAX MGMT. TRANSFER PRICING REP. 885 (Dec. 22, 2004).

acquired considerable attention because of a US$11 billion suit between two companies within the Yukos multinational corporate group.[230]

Since the United States has the most extensive litigation history regarding transfer pricing issues, U.S. case law occasionally influences other countries.[231] U.S. cases on intangibles have focused predominantly on the high-value intangibles and patents, trademarks, and their licensing; and the U.S. government has lost most of these transfer pricing cases.[232] This may be due to the complexity of transfer pricing cases, which seem to overwhelm the tax court.[233] However, U.S. case law mostly consists of applying the ancient 1968 transfer pricing regulations. When the courts start to apply the more sophisticated 1994 or subsequent regulations, a different result may occur.

Those who engage in transfer pricing litigation over intangibles should be aware of some significant taxpayer victories. In the U.S. Tax Court *Sundstrand* case,[234] the intangible was a license for manufacturing an aircraft engine part. The court upheld the multinational company's licensing agreement using evidence of

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See also Russia: Significant Amendments Proposed, Tax Planning Int'l Trans. Pricing 11 (June 2005).

[230] *Court to Proceed on $11 Billion Lawsuit Against Yukos for Abusive Transfer Pricing*, 13 TAX MGMT. TRANSFER PRICING REP. 1231 (Apr. 27, 2005).

[231] *See, e.g.*, Diahatsu Australia Pty Ltd v. FCT [2001] FC 588 (Australia). *See also*, John George Azzi, *Challenging an Australian Transfer Pricing Determination in Light of the Daihatsu Decision and the Hickman Principle*, 31 TAX NOTES INT'L 159, 170–71 (2003).

[232] The U.S. government was actually successful in litigating *Medieval Attractions, N.V., v. Commissioner*, 72 T.C.M. 924 (1996). The government's success was probably because the case involved a tax haven. A multinational company paid franchise fees of restaurant and entertainment services to a related Netherlands Antilles entity (tax haven multinational company). This tax haven company in turn paid guarantee fees to Spanish investors. The U.S. Tax Court denied the deduction for the payments to the foreign affiliates because the U.S. multinational company developed the intangibles. The payments lacked "economic substance" and were undertaken solely for tax avoidance purposes. *Id.*

[233] This complexity was expressly noted in *Perkin-Elmer Corp. v. Commissioner*, 66 T.C.M. (CCH) 634 (1993). This case involved licenses with a nonexclusive right to use and sell equipment, as well as an exclusive right to manufacture it in Puerto Rico. Because the IRS changed its reason for the assessment before trial, the U.S. Tax Court concluded the IRS's reallocation was arbitrary, capricious, or unreasonable. *Id.* at part III (9598).

[234] Sundstrand v. Comm'r, 96 T.C. 226 (1991).

similar intangibles to third parties. Sundstrand's Singapore affiliate was successful in using location savings to justify higher than normal profits. In another case involving the license of a U.S. company's pharmaceutical drug patents to a Puerto Rican subsidiary in a section 351 tax-free incorporation,[235] the courts found that at least part of the IRS' assessment was arbitrary, capricious, or unreasonable.[236]

Courts have even rejected the arguments of both governments and multinational companies, especially when a court finds that the parties' analysis is incomplete.[237] As illustrated in *H Group Holding*,[238] a court typically uses its "best judgment" to reach its own conclusion. The issue in *H Group Holding* was Hyatt hotel chain's trade name, trademark, and management services for its reservation system and corporate overhead. Hyatt claimed that its brand names were not a significant factor in the hotel industry. The IRS applied the residual profit-split method to reallocate a royalty to the parent company Hyatt. Consequently, the U.S. Tax Court created a royalty rate of 1.5% for the foreign subsidiaries' use of the Hyatt management services and a rate of 0.4% for the trademark and trade name.[239]

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[235] Governments also sometimes audit pharmaceutical companies for their use of research and development (R&D) tax benefits. In the U.S., R&D is either deducted under I.R.C. section 171 or serves as a "tax credit" (dollar for dollar reduction) under I.R.C. section 41. *See generally*, IRS, *Pharmaceutical Industry Research Credit Audit Guidelines* (Mar. 30, 2004), *available at* http://www.irs.gov/pub/irs-utl/2004pharrd.pdf.

[236] Defining the tax avoidance problem too narrowly as property transferred to a Puerto Rico possessions corporation, Congress added I.R.C. section 936(h) for intangibles transferred to a possessions corporation under a non-recognition section, such as section 351. *See* G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987). *See also* Eli Lilly & Co. v. Comm'r, 84 T.C. 996, 1131 (1985), *aff'd on this issue, rev'd in part,* 856 F.2d 855 (7th Cir. 1988) (Companies have the burden for showing that the government's allocation was arbitrary, capricious or unreasonable.); Merck & Co. v. Comm'r, 24 T.C. 73, 91 (1991). *See generally* ROBERT T. COLE, PRACTICAL GUIDE TO U.S. TRANSFER PRICING 24.03[A] (2d ed. 2001).

[237] *See, e.g.*, Seagate Technology v. Comm'r, 102 T.C. 149, 163 (1994) (The court constructed a royalty rate for the technology and know-how for hard disk drives using licensing agreements of similar patents).

[238] H Group Holding, Inc. v. Commissioner, T.C.M. (CCH) 334 (1999).

[239] Hyatt and the IRS subsequently settled the case in more detail. *See Settlements: Hyatt Group Resolves §482 Issues for Service, Royalty Fees From Affiliates*, 12 TAX MGMT. TRANSFER PRICING REP. 123 (2003).

VI. CONCLUSION

The worldwide growth of transfer pricing concerns makes it more essential that corporate advisers of multinational companies understand transfer pricing audit triggers, audit processes, and methods to resolve significant tax disputes. A multinational company adviser ought to communicate with various executives in a multinational company about preparing for a transfer pricing audit to understand what is likely to happen during an audit and to resolve it satisfactorily.

Increasingly, multinational companies must perform substantial functional, risk, contractual, and economic analyses throughout their worldwide operations. At the same time, government tax auditors ought to increase the sophistication in their APA teams in order to audit multinational companies and their transferred intangibles more fairly.

Contemporaneous documentation throughout the multinational company is critical in this whole process. Failure to conduct appropriate analyses or to document transfer pricing policies could and should result in significant transfer pricing adjustments and related penalties. These costs should be transparent in either the company's financial statements or security filings with a government's securities regulator. However, documentation requirements for small companies should not require excessively expensive transfer pricing studies that discourage worldwide business expansion.

Advisers should encourage multinational companies to consider entering into some type of APA with at least one government. Litigation is a risky approach for a multinational company even though the multinational company with an intangible at issue in a transfer pricing audit will usually achieve partial success. While there have been relatively few transfer pricing cases focusing on intangibles outside the United States, more are expected soon.