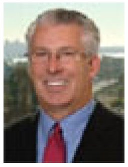

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Global Tax Headaches Over IRC Section 482

How you can avoid them.

November 29, 2007
by Blake Christian, CPA/MBT

With the explosive globalization of industry over the past two decades, IRC § 482 has become the IRS centerpiece for ensuring that taxpayers honor "arm's-length" pricing principles when structuring contractual terms for goods, intangible property, financing and services transferred between related parties. Absent this oversight, taxpayers could be tempted arbitrarily to push profits to low tax jurisdictions or otherwise to allocate tax items between domestic and foreign jurisdictions for tax minimization purposes.

The § 482 pricing rules actually apply to both purely domestic (in the case of non-unitary businesses), as well as to cross-border transactions between affiliated companies. However, the IRS has been applying this provision with increasing frequency in an international context. Transactions covered include allocation of income and expenses between affiliated taxpayers, such as the sale or transfer of tangible and intangible assets, inter-company services including management services, as well as financing arrangements between affiliates.

While inter-company pricing was generally only a concern of larger, international companies a decade ago, the combination of increased cross-border entity structuring, increased IRS audit activity, significant penalties for noncompliance, and FIN 48, § 482 has been elevated to critical importance for all companies with foreign operations — no matter what size or industry. According to Will James, Transfer Pricing Partner with BKD, LLP in St. Louis: "We are seeing the IRS raise transfer-pricing issues on the vast majority of field exams involving either privately held or publicly traded companies."

§ 482 Regulations

The § 482 regulations require companies to accumulate and maintain contemporaneous documentation *before* the filing of a federal income tax return on an annual basis to attest to the accuracy of the tax return. The contemporaneous documentation requirement applies to all forms of related-party transactions, including the transfer of tangible property, intangible property (including intellectual property), services and financing arrangements.

Taxpayers who choose to ignore these rules face accuracy-related penalties of up to 40 percent of their under-reported domestic tax. Audit and penalty exposure stretches beyond the U.S. borders (and can also have state income tax impact). "There are well over 40 foreign jurisdictions that have adopted similar cross-border pricing guidelines and also require taxpayers to maintain transfer pricing documentation or face the risk of penalties," BKD's, Will James points out. In order to avoid an adjustment and possible penalties, a taxpayer must select and apply a transfer pricing method contained in the 482 regulations (for U.S. purposes) or the Organisation for Economic, Co-operation and Development's (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (for foreign tax purposes) by which its transfer pricing activities are to be examined, or they must explain why a method not specified in the regulations or OECD Guidelines was selected.

The U.S. regulations further provide that taxpayers must present the required documentation to the IRS within 30 days of a request. James notes that the IRS has been routinely requesting the detailed transfer-pricing studies, along with the original engagement letter from the outside firm that conducted the study, in order to determine if such study was secured before the filing of the original return (which is required under the regulations). The IRS now also regularly interviews the preparer of the transfer pricing documentation to assess their level of competency. These studies range from approximately $7,500 for a basic "benchmarking" analysis, where the CPA or economist relies on the taxpayer to document the functional and industry analyses and to provide the necessary background on the inter-company transactions, and the third-party firm that then derives and evaluates the arm's length range of profit margins for specified goods or services. For more detailed analyses, the fees for fully documenting specific inter-company management fees, intellectual property royalty or tangible property transfers can run over $25,000 per contractual arrangement analyzed.

Required Documentation

The § 482 regulations mandate maintenance of several types of documentation to avoid penalties, including:

- An overview of taxpayer's business, including an analysis of business, economic, legal and other factors that affect inter-company pricing (including a functional analysis).
- A description of the taxpayer's organizational structure (including a chart) covering all related parties engaged in transactions potentially relevant under transfer pricing rules.
- All documentation required by the regulations.
- An identification of the transfer pricing methodology determined to be the best method for transfer pricing purposes, together with an explanation of why that method was selected.
- A description of the other methods considered during the best-method selection process and an explanation of why they were not chosen.
- A description of the controlled transactions and any internal data used to analyze those transactions.
- A description of the comparables, how comparability was evaluated and what (if any) adjustments were made.
- An explanation of the economic analysis and projections relied on in developing the method.

This detailed information must generally be supported by an industry expert or third-party economist, although certain taxpayers may have adequate in-house expertise to validate their methodology.

The required background documentation includes anything necessary to support the principal documents, including, but not limited to, documents identified in the § 6038A Treasury regulations.

The aforementioned documentation details and procedures are even more important for publicly-traded companies as a result of FIN 48. FIN 48 is scheduled to apply to private companies in future years. Therefore, even ignoring the IRS audit exposure, taxpayers and their CPAs must fully document the reasonableness of their domestic and foreign tax positions and net liabilities. "Section 482 is a significant issue for every publicly traded company with any foreign operations, and privately held companies should start taking a more careful look at their documentation procedures for both 482 and FIN 48 purposes," according to Jon Davies, an International Tax Partner with San Ramon, Calif-based Armanino McKenna.

For those multinationals that prefer to minimize past and future tax audit exposure associated with transfer-pricing arrangements, the taxpayer can enter into Advance Pricing Agreements, in which they disclose and obtain approval with at least one government body regarding their transfer pricing methodologies and obtain forward clearance and/or resolve past transfer pricing disputes. This has become the path of choice for many larger taxpayers and for taxpayers who have had significant disputes that could not be resolved at the field level.

The statute of limitations for transfer pricing adjustments can run as long as six years after the later of the date the return is filed or the return's due date if a substantial omission has occurred. For income tax purposes, the six-year statute of limitations can be applicable if the taxpayer omits from gross income an amount exceeding 25 percent of the gross income shown on the return.

§ 482 can certainly present taxpayers with added cross-border compliance headaches; however, the detailed regulatory guidelines provide taxpayers with a clearer picture of the documentation procedures they must maintain in order to minimize tax exposure.

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