The Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48) to clarify the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements. Transfer pricing affects the allocation of taxable income between the seller affiliate and the buying affiliate for any intercompany transaction. If the effective tax rates between these two entities differ, then uncertainty as to what will be accepted by the national income tax authorities as arm’s-length pricing will generate uncertainty as to the worldwide income tax provision even if double taxation is avoided.

FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. While the underlying principle for evaluating whether an intercompany pricing policy will be respected by national tax authorities is simply the arm’s-length standard, transfer pricing often creates substantial uncertainty for multinational corporations. Taxpayers and tax authorities often have different views as to the appropriate transfer pricing methodology and/or the precise implementation of any chosen methodology for the same intercompany transaction. Many practitioners argue:

Transfer pricing in today’s global marketplace combines technical skill with the art of diplomacy. Specialists in economics, law, accounting, and tax, must balance economics, local tax law and interpretations with the substance and form of company operations to ensure prices charged for intercompany transactions satisfy tax authorities on all sides of the transactions.

As an economist, I am often asked to give my opinion on what would represent the market price for a transaction under particular facts and circumstances. Despite the myriad of methodologies suggested by the section 1,482 regulations and the OECD Transfer Pricing Guidelines, ascertaining a reasonable estimate of the arm’s-length price requires neither diplomacy nor skills as an artist, but it does require an agreed upon representation of the relevant facts. Often transfer pricing disputes arise because the facts are either not fully articulated or not agreed upon by the parties involved.

Section I presents examples where disputes over the basic nature of the intercompany transactions may lead to uncertainty as whether an intercompany expense would even be recognized. Section II presents examples where the recognition threshold is met but uncertainty may exist as to the measurement attribute, that is, whether the intercompany price is equal to, above, or below the arm’s-length price. Both sections emphasize that a clear articulation of the facts and circumstances surrounding an intercompany transaction is key to avoiding the need for tax reserves created by uncertainty as to whether one’s intercompany pricing policies will be respected by the various national tax authorities.

1 International financial reporting standards (IFRS) for income tax accounting do not include a recognition threshold as it accounts for the uncertainty of whether a transaction would be recognized as part of the measurement attribute. While some practitioners see the proposed IFRS approach as being different from the FIN 48 approach, lack of recognition is equivalent to asserting that the more likely than not measurement should be zero.

Wal-Mart also notes that it had $0.582 billion in unrecognized tax benefits.³ Had Wal-Mart been able to recognize these tax benefits for financial statement purchases, its effective tax rate would have been 31.6 percent rather than 34.2 percent. Since Wal-Mart sources its products from third party suppliers, it does not have significant intercompany transfers of tangible goods. Wal-Mart does, however, pay an intercompany commission to its Asian procurement subsidiary for the provision of procurement services. Wal-Mart’s foreign retail affiliates also pay intercompany royalties to the U.S. parent for the use of the Wal-Mart trademark and other intangible assets owned by the U.S. parent and utilized by the foreign affiliates. We shall discuss potential recognition threshold issues with respect to not only royalties and charges for the provision of services but also for charges for loan guarantees.

### Intangible Development Costs and Royalties

Wal-Mart charges its foreign retail affiliates royalties in part because the IRS would expect the U.S. parent to receive royalty income from these affiliates. If the foreign tax authorities accept the royalty payment, the affiliate’s income would be taxed as income arising from intangible assets owned by the parent affiliate. While the foreign tax authorities may accept the payment, they may subsequently dispute whether the intangible assets are owned by a foreign affiliate or a U.S. affiliate and may seek to recharacterize the intangible assets as tax planning.

Multinational enterprises will often have foreign subsidiaries incur intangible development costs even though the intent is to have the parent own all valuable intangible assets. A classic example of this tax strategy is exemplified by Nestle, which is a Swiss parent corporation, with research facilities in other nations including the U.S. Nestle typically is careful to establish the fact that the foreign affiliates act as contract research and development (R&D) entities receiving their costs plus a reasonable profit element (also known as markup over costs) whether the intangible development project succeeds or fails.⁴ Other multinational corporations, however, have not been as careful. Consider for example a hypothetical situation where a French subsidiary of a U.S. based pharmaceutical corporation incurs R&D that were presumably for the benefit of the parent corporation, but neither was an intercompany contract R&D agreement established nor was the compensation paid to the French subsidiary during the early periods of the R&D. Audit risk may occur whether the R&D efforts are spectacularly successful or produce an intangible asset that is worth less than the R&D expenses. If the R&D efforts are successful and the U.S. parent decides to subsequently reimburse the French subsidiary at cost plus a profit element, the IRS is likely to recognize the tax planning but the French tax authorities are not. The French tax authorities will likely argue that the subsidiary should receive all intangible income and not the U.S parent. On the other hand, if the R&D efforts are not very successful, then the IRS will likely recognize the payment to the French subsidiary for the alleged contract R&D efforts, while the French tax authorities may wish to enforce the implicit contract R&D arrangement. In either case, the multinational corporation is likely to face a double tax controversy unless it can clearly document the original intent of intangible asset ownership.

### Other Service Charges

When one entity incurs expenses allegedly as services for the benefit of another entity, the tax authority of the alleged service beneficiary may question whether its local taxpayer has indeed received a benefit from the activity of the related party service provider. Consider for example the situation of a U.S. parent that it incurs costs related to the provision of managerial, administrative, and other centralized services for the benefit of the entire multinational group. Section 1.482-2(b)(ii) states that:

> Allocations may be made to reflect arm’s-length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities, as well as with respect to services performed by one member of the group exclusively for the benefit of another member of the group. Any allocations made shall be consistent with the relative benefits, respectively, of the various parties to the service rendered, and shall be made even if the potential benefits anticipated are not realized.

This benefits test addresses both whether the service recipient receives any benefit and to the degree that a benefit does occur, the proper allocation of the overall cost of providing services to the group to the specific service recipient. If the centralized activity is not deemed to benefit the operations of the specific service recipient by its local tax authority, then any charge for this activity will not be recognized. Services may be deemed not to benefit the operations of the specific service recipient for several reasons including whether they are stewardship activity (that is, activities that benefit only shareholders), duplicative (that is, an activity that has been locally performed by the foreign affiliate in question), or for other reasons. For U.S. based multinational corporations, the IRS will likely argue for inclusion of centralized cost centers while foreign tax authorities will likely argue for exclusion.

Alternatively, consider situations where the foreign affiliates of a U.S. based multinational perform activities that are allegedly for the benefit of the U.S. parent. While the foreign tax authority would expect the U.S. parent to cover the costs of these activities plus a reasonable markup, the IRS might question whether the activity was for the benefit of the parent unless a clear set of intercompany agreements are in place. As a real world example, consider a situation that an audit partner colleague sought my advice. A highly profitable U.S. financial institution had recently established a Japanese sales subsidiary. This subsidiary had incurred $10 million in upfront marketing costs but had yet to generate significant revenue. The U.S. parent paid the Japanese subsidiary $11 million on the premise that these services deserved a 10 percent markup. One member of the audit team opined that the issue was not material as the materiality threshold was so high that even a $1 million change in the intercompany price was not a concern. Another member of the audit team argued that this issue was material because

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³ Source: Wal-Mart 10-K filing for fiscal year ended January 31, 2009. We should also note that tax reserves may be established for many reasons besides disputes over intercompany pricing. That Wal-Mart had a significant tax reserve does not necessarily mean that it had significant uncertainty as to the arm’s length nature of its intercompany pricing policies.

⁴ T.C. Memo. 1996-455.

⁵ See Westreco v. Commissioner, 64 T.C. Memo 49 (1992).
15 percent of end-user sales, the manufacturer receives three-fifths and the distributor would receive a 10 percent operating margin, which represents a 40 percent markup over its production costs, the French tax authorities could have argued that these marketing expenses were for the benefit of the U.S. parent and not the local subsidiary.

If the IRS believes that all intangible assets are owned by the U.S. parent, it will assert that the intercompany price should be raised such that the French tax authorities could argue that the transfer price from 65 percent to 70 percent of end-user sales.

The French tax authorities might be tempted to disagree that all intangible assets are owned by the U.S. parent given the facts that the French subsidiary used to be an independent distributor and that the French entity incurred the upfront marketing costs after the acquisition. In fact, the French tax authorities might argue that the only valuable intangible assets were the marketing intangibles owned by the French subsidiary. In this case, the French tax authorities might argue that the Comparable Profits Method be applied to the U.S. manufacturer as the tested party such that it would be entitled to only a routine return for manufacturing. If this analysis established that the routine return to manufacturing represented at most a 20 percent markup over production costs, which is the equivalent to 10 percent of end-user sales in our example, the French tax authorities could argue that the transfer price be lowered from 65 percent to 60 percent of end-user sales.

Effectively, our example assumes that consolidated residual profits represent 10 percent of sales. Which legal entity is entitled to these residual profits becomes a question of fact as to what are the valuable intangible assets and which legal entity owns them. Under the actual transfer pricing policy, the residual profits are split evenly between the U.S. manufacturer and the French distributor. If all of the intangible assets were owned by the U.S. manufacturer, the IRS argument that U.S. taxable income be increased by 5 percent of European sales would have merit. If the only valuable intangible asset were French owned marketing intangibles, the argument put forth by the French tax authority that French taxable income be increased by 5 percent of European sales would have merit. If European sales were $100 million, the uncertainty of what would represent an arm’s-length transfer pricing policy leads to a range of possibilities from the prospect that French income being raised by $5 million to the prospect of U.S. income being raised by $5 million.

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7 While our focus will be on the allocation of the substantial profits in 2008 and the implications for the transfer pricing of goods for that year, a recognition threshold issue could have been raised during the early period of the market share strategy. If the French affiliate were incurring operating losses during this early period, the French tax authorities could have argued that these marketing expenses were for the benefit of the U.S. parent and not the local subsidiary.
Whether a transfer pricing reserve should be established and how large that reserve needs to be depends on several factors including the effective tax rates of the two nations, whether or not the multinational corporation intends to vigorously fight for its rights not to be double taxed in a Competent Authority process, and which position is more likely than not to prevail under audit by one of both of the tax authorities. Assume that the U.S. tax rate is 40 percent and the French tax rate is 34 percent. If the Competent Authority process works, the multinational would face additional taxes only to the degree that the IRS sustains a section 482 adjustment. Even if the IRS were able to sustain a section 482 adjustment equal to 5 percent of sales or $5 million, the tax reserve would be only 6 percent (40 percent minus 34 percent) of the section 482 adjustment or $300 thousand if the French authorities ultimately agree to the section 482 adjustment. If the Competent Authority process does not work to resolve a double tax dispute between the IRS and the French tax authorities, it is possible that the multinational would be double taxed on $10 million if the French authorities sustain a $5 million reduction in the transfer price paid by the French distributor and if the IRS sustain a $5 million increase in the transfer pricing received by the U.S. manufacturer. In this case, the multinational faces the prospect of paying $3.7 million in additional income taxes.  

If the multinational can establish a reasonable methodology closer to its original transfer pricing position and if this methodology is deemed more likely than not to prevail under audit, transfer pricing reserves can be mitigated. The facts in this hypothetical example suggest a credible argument exists for the application of the Residual Profit Split Method, where the U.S. manufacturer owns the product and process intangibles, as well as, perhaps a naked trademark, while the French distributor owns other marketing intangibles. Whether or not these facts would support the 50/50 split of residual profits implied by the transfer pricing policy depends on the relative value of the intangible owned by the French distributor versus the U.S. manufacturer. A detailed transfer pricing analysis would include the terms of the original acquisition of the distributor and the history of its upfront marketing expenditures since the acquisition.

**Royalties for the Use of Intangible Assets**

Our second example will assume that Armstrong, Inc. decided to have its French affiliate manufacture the shoes that it sold to European customers. Because the French affiliate utilizes the product and process intangibles owned by the U.S. parent as well as the naked trademark, the French affiliate would be expected to pay royalties to the U.S. parent for the use of these intangible assets. Our example will continue to assume that production costs represent 50 percent of sales and that distribution costs represent 25 percent of sales. The French entity bears both of these expenses and therefore generates operating profits before royalty payments equal to 25 percent of sales. We shall also assume that the intercompany royalties equal 5 percent of sales.

The transfer pricing issue is whether the arm’s-length royalty rate is greater than, less than, or equal to 5 percent. Section 1.482-4 lists three methodologies for evaluating intercompany royalties:

- The Comparable Uncontrolled Transaction Method
- The Comparable Profits Method
- The Profit Split Method.

The Comparable Uncontrolled Transaction Method could be reliably utilized if Armstrong licenses the same intangible assets to a third party under the same conditions. While such internal applications of the Comparable Uncontrolled Transaction Method may prove useful when an owner of intangible assets licenses to both third party licensees and affiliates, it is often the case that the same intangible assets are not licensed to third parties. The use of external comparable agreements, that is, licenses of similar intangible assets between third parties is often seen as not being a reliable approach unless adjustments are made for the differences in the profit potential in the third party agreements versus the intercompany agreement. As such, the transfer pricing analysis may be based on one of the two profits based approaches.

The IRS could argue that the intercompany royalty be increased from 5 percent to 10 percent on the basis of an application of the Comparable Profits Method. This application would first estimate the routine returns to the distribution and production functions undertaken by the French subsidiary licensee. We earlier argued that these routine returns sum to 15 percent of end-user sales such that residual profits equal 10 percent of sales. This approach not only assumes that the U.S. parent owns all valuable intangible assets but also presumes that 100 percent of residual profits accrue to the owner of the intangible assets. The French tax authorities, however, could argue that the French affiliate deserves a portion of these residual profits by noting two possibilities. One possibility is simply that licensees receive a portion of residual profits simply because they undertaken extra risk by running an enterprise utilizing another entity’s assets and pay the owner a fixed percentage of sales regardless of whether the enterprise is highly profitable or not. The other possibility is that the French affiliate be deemed to be the owner of certain marketing intangibles. In fact, the French tax authorities might argue that a 5 percent royalty rate was above the arm’s-length standard if they believed that the French owned marketing intangibles were more valuable than the intangible assets owned by the U.S. parent.

As we noted in our discussion of the tangible goods pricing controversy, the multinational would face additional taxes only to the degree that the IRS sustains a section 482 adjustment. Even if the IRS were able to sustain a section 482 adjustment equal to $5 million by arguing for a 10 percent royalty rate, the tax reserve would be only 6 percent (40 percent minus 34 percent) of the section 482 adjustment or $300 thousand if the French authorities ultimately agree to the section 482 adjustment. If the Competent Authority process does not work to resolve a double tax dispute between the IRS and the French tax authorities, it is possible that the multinational would be double taxed on the divergence between the royalty rate expected by the IRS versus the royalty rate allowed by the French tax

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8 If the IRS sustained cumulative transfer pricing adjustments in excess of $5 million, it might also assess section 6662 penalties unless the taxpayer provides contemporaneous documentation that the transfer pricing policy had a reasonable basis for being deemed to be arm’s length. Essentially, a reasonable basis requires that the transfer price be based on a appropriate application of an appropriate method given the facts and circumstances surrounding the intercompany transaction.

9 Even if a reliable application of the Residual Profit Method proved infeasible, one could evaluate the appropriateness of the 35 percent gross margin for the French distributor with an application of the Market Share Strategy under section 1.482-1(f).
authorities. If the multinational is able to establish a convincing argument that the arm’s-length royalty rate is consistent with its intercompany royalty rate, the need for tax reserves would be mitigated.

**OTHER CONSIDERATIONS**

Unit of account considerations assist tax professionals understand the logic of transfer pricing considerations in terms of how uncertainty over transfer pricing issues translate into the possible need for tax reserves. The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account depends on the manner in which the taxpayer prepares and supports its income tax returns and the approach that the taxing authorities may take during an examination.

Since transfer pricing involves the taxable income of both the seller affiliate and the buyer affiliate, differences in how the two relevant tax authorities may view the appropriate unit of account may exists. We noted the example where Armstrong, Inc. licensed the use of its intangible assets to its French affiliate. While the IRS might view this issue in terms of the appropriate operating margin for the French licensee, the French tax authorities might view this issue in terms of the appropriate royalty rate without regard to the operating margin of the licensee. As another example of where the IRS might deem the operating margin of a foreign affiliate to be the appropriate metric for evaluating transfer pricing, consider a situation where a U.S. manufacturer sells finished goods to its Japanese distribution affiliate. The IRS typically views such tangible goods transfers in terms of the Comparable Profits Method applied to the Japanese affiliate as the tested party. The Japanese NTA, however, often views such issues in terms of what is an appropriate gross margin under the Resale Price Method.

In conclusion note that tax practitioners often see the securing of an Advance Pricing Agreement (APA) as removing uncertainty for the covered transaction during the term of the APA. While this statement is true, it can also be deceiving unless one understands the time consuming and often expensive process of obtaining an APA. Taxpayers are well advised to prepare a thorough statement of facts surrounding the covered transaction and to develop a very well reasoned economic analysis to support the position that they hope the APA will adopt. If the APA program believes the transfer pricing position is too aggressive, then the taxpayer may be asked to agree to a less aggressive position. Taking less aggressive positions and preparing thorough documentation that the position is consistent with the arm’s-length standard may serve to alleviate the need for FIN 48 reserves related to transfer pricing uncertainty even if the taxpayer has not obtained an APA.