

TRANSFER PRICING ALERT

Transfer Pricing: The IRS Remains Vigilant

The Internal Revenue Service continues its emphasis on transfer pricing making the need for quality contemporaneous documentation as strong as ever.

Recent activities by the Internal Revenue Service (“IRS”) including training of its examiners and temporary regulations in accordance with Internal Revenue Code (“IRC”) §482 indicate the importance it places on enforcing transfer pricing for both inbound and outbound taxpayers.

International Practice Units – Examiners Gain the Skills and Expertise

One of the relatively new training tools the IRS is using to enhance its examiners skills and expertise is the issuance of International Practice Units (“IPU”) on a variety of topics. For transfer pricing, the IPU’s are meant to provide IRS examiners with step-by-step instructions on how to approach and analyze transfer pricing issues. Already in 2016 alone, the IRS issued 6 new IPU’s on topics including how to review transfer pricing documentation (“**Documentation IPU**”), and use of the resale price and residual profit split methods. Add this to the approximately 20 issued in prior years and you see that transfer pricing is still high on the IRS enforcement list.

The Documentation IPU issued on March 4, 2016, advises examiners to review other information returns (such as the Form 5471 and Form 5472) to identify any related party transactions that the documentation might not cover. After reading the documentation the examiner should have a good understanding of the taxpayer’s business. Also, although supporting documents aren’t a specific requirement it is important that the taxpayer be able to provide the examiner items such as the intercompany agreements.

The Documentation IPU is a reminder to taxpayers that it is not only important to maintain contemporaneous documentation but to ensure the quality of the content. The Documentation IPU clarifies that merely having a transfer pricing study that includes the 10 principal documents isn’t necessarily sufficient to avoid transfer pricing penalties under IRC §6662.

This is why at Funaro & Co., PC (“**Funaro**”) we strive to ensure the documentation tells the taxpayer’s “story.” After reading the documentation, the examiner should understand your business, your related party transactions, how the method selected is the “best method” and persuasively concludes that the intercompany transactions are arm’s length. This is the best way to avoid a transfer pricing penalty.



Temporary IRC §482 Regulations – The Expansion of Aggregation

Another way for the IRS to enhance enforcement is through regulations. On September 14, 2015, the IRS released Temporary Regulations (“**Temp. Regs.**”) that clarify the coordination of the arm’s length standard and the best method rule under IRC §482 with other provisions of the IRC. The Temp. Regs. are another attempt by the IRS to require that taxpayers capture the true “total value” of a transaction. To do this they expand upon the concept of aggregation.

For instance, the Temp. Regs.:

- add a new clause to clarify that the aggregation principle also applies under multiple provisions of the Code or regulations;
- they add a new sentence elaborating on the aggregation principle by stating that consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation is consistent with the value provided, including any synergies among items and services provided; and
- remove the requirement that transactions be aggregated only when they involved related products or services.

What is most telling about the Temp. Regs. is the new examples. For instance, **Example 5** illustrates the aggregation of interrelated patents. It provides that when a taxpayer is licensing 10 patents as a bundle, licenses of similar individual patents are not comparable. Instead, as the example reflects, the bundle (which could earn profits of \$25) is more valuable than 10 separate patents which would only earn a \$1 each for a total of \$10.

Example 10 illustrates that what the taxpayer may consider merely the provision of services also includes intangibles which must be aggregated as part of the transaction. Here, Parent’s (“**P**”) R&D Team created Product X which it markets worldwide. P’s R&D Team has specialized knowledge and expertise. Building on the platform of Product X, the P R&D Team is planning to provide R&D services to create a new line of products to be owned and exploited by S1. P alleges that the arm’s length charge for the services is only reimbursement to P of its associated R&D Team compensation costs. The example concludes that the best method to determine compensation is to aggregate the value of the services and the embedded value of the platform and knowhow.

Budget Cuts Just Mean New Approaches Not Less Enforcement

With continuing IRS budget cuts the agency continues to struggle to find effective and efficient approaches to maintain enforcement. However, despite the struggles it continues its interest in transfer pricing and there is no expectation of any decline.

To meet its new challenges, the Large Business and International Division (“**LB&I**”) started a restructuring plan in early 2016. The “new” LB&I creates “practice areas” based on subject matter and geography. It is also changing its audit approach to one based on “campaigns” focused on perceived areas of noncompliance. Although not known for certain, it is fairly likely that transfer pricing will retain its importance and continue as a heavily audited issue.

Stay tuned for our next installment - Avoid the Audit – Negotiate an APA



TRANSFER PRICING SERVICES

Funaro & Co.'s Transfer Pricing Team provides transfer pricing planning, documentation and dispute resolution services, including:

ASSESSMENT OF POTENTIAL ADJUSTMENTS AND PENALTY RISKS: to fully comprehend the exposure to transfer pricing adjustments, assist firms in minimizing potential penalties and implementing FIN 48 reporting standards.

TRANSFER PRICING POLICY: our multi-skilled consulting team can help you plan your global transfer pricing strategy and optimize results by allocating assets, functions and risks in the appropriate jurisdictions.

BENCHMARKING ANALYSES: to determine the target profit margins based on proposed scenarios utilizing data from proprietary databases.

VALUATION OF INTANGIBLE PROPERTY: to determine the arm's length royalty rate or lump-sum amount for intercompany transfers of intangibles.

CONTEMPORANEOUS DOCUMENTATION STUDIES: to comply with the Treasury Regulations, reduce the likelihood of a transfer pricing adjustment and avoid the potential assessment of penalties as a result of IRS examinations.

DISPUTE RESOLUTION: representation of taxpayers during transfer pricing examinations, negotiation of Advance Pricing Agreements and submission of Competent Authority assistance requests to reduce the risk of double taxation.

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ABOUT FUNARO & CO.

Funaro & Co. is a leading medium-sized audit and tax advisory firm. Founded in 1947 to service the unique needs of Italian companies with operations in the U.S, our firm has grown steadily over the years and the scope of our services has grown with us. For over 70 years, Funaro & Co.'s unmatched U.S./E.U. cross-border experience has kept us solidly in a position of leadership in our profession. With more than 100 employees and offices in New York, Miami and Milan, the size of our firm is small enough to provide an unusual degree of personal service, yet large enough to provide every type of professional support required by its clientele.

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