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## Why Is Transfer Pricing a Top Concern?

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For decades, corporate tax executives have asked what tax issues cause them the greatest concern.<sup>1</sup> Transfer pricing is consistently listed at or near the top of that list. The reasons listed below explain much of the reason why.

### **NEARLY HALF OF ALL U.S. IMPORTS AND EXPORTS INVOLVE THE TRANSFER PRICING ISSUE**

Transfer pricing controls the tax treatment of cross-border transactions between related parties. According to U.S. Census Bureau statistics, 42.6% (\$1.602 trillion) of total U.S. imports and exports were between related parties in 2020.<sup>2</sup> Each of these transactions involve transfer pricing. The actual scale of transfer pricing is even higher because the Census Bureau data does not include intercompany services, loans, and intangibles payments in its statistics.

### **SHEER SIZE OF THE POTENTIAL ADJUSTMENT**

Transfer pricing has been the subject of the largest tax disputes in U.S. Tax Court history. In 2006, the

IRS settled with GlaxoSmithKline for \$3.4 billion in additional tax, penalties, and interest in a transfer pricing dispute — the largest single payment made to resolve a tax dispute.<sup>3</sup> Over the years, companies have had success against the IRS in transfer pricing disputes. Recently, the IRS prevailed over Coca-Cola in Tax Court regarding amounts charged to foreign affiliates in connection with their intercompany licensing agreements. The decision produced an additional tax liability of \$3.3 billion.<sup>4</sup> The taxpayer intends to appeal. As of July 1, 2022, the taxpayer carried a tax reserve for this issue of \$414 million and estimates a potential deficiency of \$13 billion should the Tax Court position be confirmed.<sup>5</sup>

Transfer pricing disputes are not limited to the largest multinationals. The amounts in issue with smaller

<sup>3</sup> See IR-2006-142.

<sup>4</sup> *Coca-Cola Co. v. Commissioner*, 155 T.C. No. 10 (2020).

<sup>5</sup> The Coca-Cola Company, Form 10-Q for quarter ending July 1, 2022.

The Company's conclusion that it is more likely than not the Company's tax positions will ultimately be sustained on appeal is unchanged as of July 1, 2022. However, we updated our calculation of the methodologies we believe the federal courts could ultimately order to be used in calculating the Company's tax. As a result of the application of the required probability analysis to these updated calculations and the accrual of interest through the current reporting period, we updated our tax reserve as of July 1, 2022 to \$414 million.

While the Company strongly disagrees with the IRS' positions and the portions of the Opinion affirming such positions, it is possible that some portion or all of the adjustment proposed by the IRS and sustained by the Tax Court could ultimately be upheld. In that event, the Company would likely be subject to significant additional liabilities for tax years 2007 through 2009, and potentially also for subsequent years. . . The Company estimates that the potential aggregate incremental tax and interest liability could be approximately \$13 billion as of December 31, 2021.

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<sup>1</sup> See EY, *How Leaning Into Transfer Pricing Transformation Helps Manage Tax Risk* (2021).

<sup>2</sup> U.S. Goods Trade: Imports and Exports by Related Parties, 2020.

multinationals may not be as large in absolute amount; however, transfer pricing adjustments loom large in proportion to the revenues of those multinationals.

### **BREADTH OF EXPOSURE**

A transfer pricing issue can be initiated by any affected country. In most cases, only two countries are affected, but some royalty arrangements or headquarters cost allocations can affect multiple countries. Further, the number of countries that enforce transfer pricing rules has risen dramatically over the last three decades to more than 70.<sup>6</sup> Over 60 countries tracked by the OECD have had transfer pricing disputes employing the mutual agreement procedure.<sup>7</sup>

### **PENALTIES OF 20% AND 40% FOR SUBSTANTIAL MISSTATEMENTS**

Section 6662(e) and §6662(h) impose 20% and 40% non-deductible penalties for transfer pricing valuation misstatements which produce an increase in U.S. income tax. A carve-out is available for transactions for which the taxpayer reasonably relied on a transfer pricing approach. Adjustments are excluded from the net §482 adjustment calculation to the extent the taxpayer can demonstrate that it determined its price using one of the transfer pricing methods enumerated in the §482 regulations in a reasonable manner.<sup>8</sup> Although the regulations do not require transfer pricing documentation, it has become widespread practice, because careful documentation can demonstrate the reasonableness of transfer pricing determinations, thereby avoiding penalties.

Other countries also impose penalties for reported transfer pricing results that deviate from an arm's-length result, especially where the deviation is significant and the taxpayer is unable to demonstrate that it made a reasonable effort to comply with domestic law transfer pricing requirements. Careful documentation can also be important to avoiding foreign country transfer pricing penalties.

### **FINANCIAL AND TAX REPORTING**

Financial reporting rules under Accounting Standards Codification (ASC) 740 require companies to identify and report on the financial statement certain uncertain tax positions (UTPs) over a minimum recognition threshold. Tax positions (including transfer pricing) are evaluated using a two-step process. The first step is recognition or non-recognition of a tax position, based on the technical merits, that the position

will be sustained upon examination.<sup>9</sup> If the position is recognized, the second step is measurement of the tax benefit. The tax benefit "shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information."<sup>10</sup> Given the size of transfer pricing issues and the IRS scrutiny of transfer pricing transactions, transfer pricing has become one of the most significant UTPs.

The IRS requires similar reporting for corporations on Schedule UTP (Form 1120).<sup>11</sup>

### **RESOLUTION OF TRANSFER PRICING DISPUTES AND CORRECTION OF TAX AND FINANCIAL REPORTING IS COMPLICATED AND EXPENSIVE**

Transfer pricing differs from other tax issues in two important ways that make the resolution and correction of transfer pricing issues more complex and more expensive. First, transfer pricing is a cross-border issue, requiring agreement between the taxpayer and at least two tax authorities. Second, because transfer pricing for tax and financial statements must generally agree, financial statements must be adjusted to conform with the transfer price agreed for tax purposes.

The cross-border nature of transfer pricing issues creates complications not encountered with other tax issues. Instead of negotiations between the taxpayer and IRS, transfer pricing disputes involve the taxpayer, the IRS and at least one other tax authority. The procedures to resolve transfer pricing between countries and achieve correlative relief for the taxpayer are complex and expensive due to the size, complexity and ambiguity of transfer pricing issues and the need to satisfy at least two countries. Even after resolution of the transfer pricing issue, the process to amend tax returns is complicated and expensive. Once the IRS, the other country involved, and the taxpayer agree on transfer pricing adjustments, the taxpayer must file amended returns reflecting those adjustments for each affected year in each country. Since a change in federal taxable income generally affects the state tax base, amended state tax returns are also likely. Finally, companies that use transfer pricing analysis to value goods for Customs purposes may need to make a revised Customs filing.

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<sup>9</sup> FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109 (June 2006).

<sup>10</sup> FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109 (June 2006).

<sup>11</sup> Instructions for Schedule UTP (Form 1120).

<sup>6</sup> OECD, Transfer Pricing Country Profiles.

<sup>7</sup> OECD, Mutual Agreement Procedure Statistics per Jurisdiction for 2020.

<sup>8</sup> §6662(e)(3)(B)(i). Note that these methods are referred to as "specified methods" in the regulations for this section.

Unlike other tax issues, the transfer price developed for tax purposes must generally agree with the transfer price used in financial reporting. Therefore, entries are required to “conform” the taxpayer financial accounts to agree with the transfer pricing agreed for tax purposes.<sup>12</sup> This adjustment may include the treatment of an allocated amount as a dividend or capital contribution, or possibly intercompany deemed in-

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<sup>12</sup> Reg. §1.482-1(g)(3).

debtedness.<sup>13</sup> In any event, this type of effort is well beyond that required in connection with the resolution of other tax issues.

### ***CONCLUSION***

Transfer pricing issues will continue to command attention from corporate tax executives due to the size, complexity and subjectivity of transfer pricing determinations, the involvement of multiple countries in the dispute, and the harsh penalties and reporting requirements.

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<sup>13</sup> Reg. §1.482-1(g)(3).