Transfer Pricing and IRC Section 482

Dorothy M Hong
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Dorothy Hong November 2010

Introduction: Doing Business in South Korea or with Company based in South Korea

In keeping with the spirit of Republic of Korea’s President MB Lee policy of “business-friendly tax environment,” South Korea which has been a member of OECD since 1996 and with bilateral US-Korea Tax Treaty since 1980 whose copy of treaty is easily accessible on IRS website, transfer pricing rules as they relate to IRC Section 482 play a pivotal role in setting a course of direction for any MNE doing business in South Korea or with South Korea or for that matter any South Korean Chaebol caliber type company doing business in US or with US. “An SME is not exempt from compliance with Section 482 of the IRC; however, if the volume of transactions is sufficiently low, penalties under Section 6662 of the IRC will not apply”

Here is a glimpse of transfer pricing rules dynamics: “One recent proposal [in 1995] seeks to accomplish this goal [of negative safe harbors] by eliminating the dollar limits in the temporary regulations and encouraging IRS to focus not only on the overall size of the company, but also on the amount of related-party transactions when determining limits for applicability. Essentially, the proposal encourages the IRS to make safe harbor [i.e. certain limited protections against requirements when taxpayer used the best method rule] determination, within a certain range, on a case-by-case basis.”

As is the tradition of IRS with respect to issue of transfer pricing, its regulations are “in temporary rather than final form and the new temporary regulation, which went into effect on January 5, 2009” until December 30, 2011, amended cost sharing agreements and set new documentation rules, among others.

Definition of Transfer Pricing

The price charged within an organization, or between related parties, for the exchange of tangible property, services, intellectual property, assets, and funds is referred to generally as transfer pricing.

1 See, e.g. Korea, Asia Pacific Tax Notes, (PricewaterhouseCoopers, 2010), 634116904779682323_aptn23_jun2010.kr.pdf
5 Ross K..Krutinger, Ouch, You’re Twisting my Arm’s Length: The Arm’s –Length Standard View of Xilinx, Inc. v Comm’r and the 2009 Cost-Sharing Regulations, at 1 (November 24,
allocation of profits among its various related entities, thereby affecting the amount of income taxes payable to various tax authorities.  

IRC Section 482
According to IRC Section 482, the arm’s length standard applies to transfer pricing and taxation of transaction within an organization. If a transaction between related entities does not satisfy the arm’s length standard by way of discounts, inside mark down pricing or otherwise indicates favoritism then the Commissioner of Internal Revenue has the authority to reallocate income, deduction, credits, and allowances in order to determine true taxable income and as necessary to prevent tax evasion.

Transfer Pricing Analysis in Global Economy with Decentralization and Licensing of IP Rights
“Businesses are becoming increasingly integrated in order to achieve economies of scale, profit and product diversification, market penetration, complementary product production, and other business goals.” As such “[t]he arm’s length standard is increasingly hard to determine where something is produced, designed, created, adjusted, or somehow had value added,” e.g., Dell and Samsung Electronics. By licensing technology to a foreign subsidiary, US-based corporations are able to shift income to foreign subsidiaries so that profits are earned outside the US and taxed at lower foreign rates. The foreign subsidiary is outside the reach of US taxation, but the license agreement with the US corporation is subject to transfer pricing regulation of Section 482 and the arm’s length standard. Yoon argues, “The autonomy created by decentralization makes it possible for the R&D division to provide a patent to a rival. The licensing decision ultimately enhances a firm’s total profit despite the loss to its downstream [i.e. production and marketing] division because the investment incentive and

2010) (On file with Author) Available at http://lawlib.wlu.edu/works/734-1.pdf
Kelly Chen, Overview of US Transfer Pricing Issues and New Cost Sharing Regulations Issued by IRS, The Practical Tax Lawyer Volume 23, Number 4, at 23 (Summer 2009)
Compare §1.09 of the OECD Model Tax Convention
See generally Krutsinger at 1-2
http://digitalcommons.law.ggu.edu/annlsurvey/vol3/iss1/9
Id. at 198
See, e.g. Dae-Hee Yoon, a Yale PhD Candidate, Strategic decentralization, bargaining, and transfer pricing in supply chain efficiency, (Proquest LLC, 2008) (B&N Nook Study)
the upstream [i.e. research, development, investment project] profit are both improved.\textsuperscript{13}

Figure 3.2 – The sequence of events under vertical licensing\textsuperscript{14}

<table>
<thead>
<tr>
<th>If the new product is feasible, upstream division and downstream division negotiate</th>
<th>Downstream division and a rival simultaneously decide quantity</th>
</tr>
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<tr>
<td><strong>Timeline Period</strong></td>
<td><strong>Upstream (R&amp;D) division makes investment decision</strong></td>
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“[The] US tax policy may enable a US multinational corporation to offset foreign taxes between high tax-rate foreign country and a low tax-rate country. The high tax rate foreign country may create unused foreign tax credit while the low tax-rate foreign country may result in additional tax liability. … [B]oth high tax-rate and low tax-rate countries can offset against each other to produce lower tax liability via tax strategy creating more foreign tax payment than US tax liability. It leads to the use of more foreign tax credit to offset against the US tax liability, resulting in lower tax payment to the US government. [Because] the foreign tax credit is given in one amount per US parent company for all of its foreign branches and foreign subsidiary corporations as a whole, not in piece-meal, the tax credit between a foreign branch and a foreign subsidiary corporation of [a US parent company] can offset each other.\textsuperscript{15} In this regard IRC Sec. 904 “foreign tax credit limit” is “designed to maintain at least single taxation, so that affected US taxpayers are kept on par with other foreign and domestic taxpayers” depending on whether business activity abroad produced and is categorized as dividend taxed under IRC Section 301(a) or a return on capital which does not generate foreign tax credits.\textsuperscript{16} Another US phenomenon is a corporate inversion where a multinational group based in US via reorganization becomes a foreign corporation in

\textsuperscript{13} Yoon at 57
\textsuperscript{14} Yoon at 69
US and instead incorporates in a “tax haven” offshore country mainly “to get reduction of the corporate tax burden,” as the current US taxation system is perceived by many American multinationals as too harsh compared with other tax systems, ... causing “a competitive disadvantage of US multinationals compared with multinationals based in other jurisdictions,” e.g. McDermott move to Panama in 1980’s (South America) and Banneker to _____ in 2010 (Africa)

**Tax Treaties**

South Korea’s close ally and neighbor, Japan whose new bilateral tax treaty with the US which went into effect in January 1, 2005 keeps pace with pulse of Japan’s post-Asian economic crisis political social economy and many of the treaty provisions complement or are similar to laws of this land in so far as arm’s length standard for the international norm for policing transfer pricing and corollary to this the commensurate-with-income standard for the intangibles mirroring IRC Section 482. US-Japan Tax Treaty of 2006 also takes into account of the exception scenario to the foreign corporation earnings not taxed until repatriated to Japan in an anti-deferral regime similar to subpart F under US tax law. Generally, the cross-border income tax provisions may be referred to by analogy in IRC Subchapter N.

Finally, the Japan-US Memorandum of Understanding (“MOU”) resolved factual disagreement on the interpretation of the meaning of “investment bank,” as limiting to those activities giving rise to at least sixty percent of the bank’s gross income for each of the three tax years preceding the tax year in which the interest payment arising from the “investment bank activity” is made. Similarly, the scope of factual disputes factors determining the transfer price for transactions, for instance, can be entered into as being covered under Mutual Agreement Procedure (MAP) of a tax treaty.

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18 *Id.* at 2-3
19 *But see id.* at 4-10 on Sartori’s discussion of the American Jobs Creation Act of 2004, an anti-inversion legislation enacted and included in IRC Section 7874
21 *Id.* at 805
22 *Id.* at 806
23 *See generally* 59 Tax Lawyer 3; *see also id.* at 699-703
25 MOU is defined in IRS Announcement 2006-7, 2006-1 CB 342; electronic citation 2006 TNT 14-8
www.law.uh.edu/faculty/wstreng)
As statutory laws and treaties are equal in rank with later in time prevailing where there is conflict as between that of domestic legislation and treaty provision, IRC Section 482 as applied to South Korean economic activities giving rise to businesses including industrial and commercial activity as defined in Article 8 of the United States-Republic of Korea Income Tax Convention ratified in 1979 and proclaimed by President in 1979 and given effect under Article 31 on January 1, 1980 having effect or impact in Contracting States may apply to revenues derived mentioned therein. A tax treaty may be amended by protocol upon consent of Senate and its ratification requires explanation before the Senate Foreign Relations Committee by both US Treasury Department representatives and members of the Staff of the Joint Committee on Taxation.\(^\text{27}\) By the same token OECD published Model Tax Convention on Income and Capital in 2005 for members use in their negotiations of bilateral double tax treaties, ostensibly in keeping with the traditional role of the bilateral tax treaty to remove unnecessary tax barriers to cross-border trade and investment flows between contracting states and prevent double taxations by assigning or allocating tax burden to source state, i.e. country in which the income arose.\(^\text{28}\) Under the mutual agreement procedure article of tax treaty, double taxation disputes may be resolved in a situation where application of US and a treaty partner tax rules produced double taxation.\(^\text{29}\) e.g, In 2006 SONY Corp. and its affiliate SONY Computer Entertainment Inc. (SCEI) and its US subsidiary were double taxed in US and Japan.\(^\text{30}\)

The tax authorities of a number of nations, including the United States, are increasing their review of transfer pricing practices, particularly internationally within and between multinational corporations. This heightened scrutiny is not surprising since it is estimated that nearly half of all trade among advanced nations takes place between related parties.\(^\text{31}\) [Likewise], “[t]he appropriate source taxation of the income from intellectual property, like patents, is one of the most controversial issues between developed and merging economies. The position of the developing world was articulated in the Manila Declaration, which adopted the position that royalties should be treated as distributions of profits where the

\(^\text{27}\) Id. at 30-31
\(^\text{28}\) Fuller at 774-793
\(^\text{29}\) Levey, Marc M. Levey, Steven C. Wrappe, Kerwin Chung, Transfer Pricing Rules and Compliance Handbook at 102 (CCH, 2006)
\(^\text{30}\) SONY and SCEI filed a complaint in 2006 with Japan’s Income Tax Tax Appellate Tribunal (ITAT) after being ordered to pay $242.6 million in additional taxes between SCEI and its US subsidiary subsequent to their payment of taxes to IRS in US., Julian Ryall, Japanese Tax Authorities bill SONY $243 million for undeclared income, The Hollywood Reporter (July 1, 2006)
\(^\text{31}\) Kayfetz at 199
parties were related, and thus would not be deductible but would be subject to withholding. The standard argument for the host’s right to tax the royalty income from patent is that the host is providing the environment and protection for its utilization.”

Utility of Transfer Pricing Analysis
Review of transfer pricing rules is a good exercise during this economic situation triggering tax audit citing “a sudden reduction in taxable profits” and other scenarios pointing to business restructuring because methodologies, calculations and documentation for transfer prices shed light to current economic problems and may meet other similar compliance requirements which a company as a matter of routine business practice would have engaged in anyway, e.g. filing Advance Pricing Agreement (“APA”) or filing under Section 404 of Sarbanes-Oxley Act of 2002. While the US transfer pricing regulations make it clear that the IRS will evaluate the taxpayer’s transfer price based on results rather than the method used to determine price, tax examiners in foreign countries often focus their examination on the taxpayer’s method used to set prices. Therefore, the taxpayer may benefit from presenting the taxpayer’s results under several methods, depending on the degree of acceptability in each country.

Transfer Pricing Methods (TPM)

Figure 3-1: Transfer Pricing Methods for Arm’s-Length Charge

Transfer Pricing Methods**

<table>
<thead>
<tr>
<th>Transactional Methods</th>
<th>Profit-Based Methods</th>
<th>Unspecified Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comparable Price (CUP)</td>
<td>Resale Price (RPM)</td>
<td>Cost Plus Method</td>
</tr>
<tr>
<td>Uncontrolled Method</td>
<td></td>
<td></td>
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<tr>
<td>Profit Unspec.</td>
<td>Plus Method</td>
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<tr>
<td>Profits Split Method</td>
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</table>

*Similar to the Transactional Net Margin Method (TNMM) used in OECD countries.
(The American “best method” rule is unique and far tougher than the OECD guidelines,

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33 Levey et al. at 99
34 Levey et al. at 99
35 Id. at 23
which have a hierarchy of methods and which American rules otherwise track (reg. section 1.482-1(c)(1)). But the expectation of comparable uncontrolled prices is being subsumed by the lack thereof and multinational taxpayers’ preferences for the profit-split methods like the transactional net margin method, which are formulaary apportionment by another name. The OECD guidelines consider profit-split methods to be methods of last resort.36 “[OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any distortions and thereby ensure that the arm’s length principle is satisfied. OECD member countries consider that an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances.”37 In arriving at arm’s length price or margin OECD factors “(1) selecting the most appropriate point in the range, and (2) extreme points: comparability considerations that is, for instance, loss-making uncontrolled transactions.”38

**For intangibles, taxpayers can use three specified methods: the comparable uncontrolled transaction (CUT), the profit split method and the comparable profits method. … The IRS, in general, utilizes Standard & Poor’s Compustat and Global Vantage databases to perform analyses using comparables companies. [Other accepted databases include] Bureau van Dijk’s OSIRIS, Amadeus, Jade, and Fame databases, and Worldscope databases.39

Discussion as to the appropriateness of choice of one transfer pricing method (“TPM”) over another is a matter of factual dispute sometimes left for the Tax Court in the course of transfer pricing disputes, but the general thumb nail rule delineated in Basuch & Lomb40 case is as follows as to the sale of tangible property in accordance with Sec. 1.482-2(e)(1)(ii)-(iii): (92 TC 525, 584-5) (1) use of CUP if comparable, uncontrolled sales of the tangible property in question exist; (2) use of RPM if no comparable, uncontrolled prices exist and if the standards for its applications are met; (3) use of Cost Plus method if RPM is not feasible, that is requirements of application for RPM are no present and where the controlled seller has added substantial value to sale of goods e.g. Treasury Regulation Sec. 1.482-2(e)(4)41.

36 See also Lee Sheppard, News Analysis: Inbound Transfer Pricing as Beggar thy Neighbor. (Section 482-Transfer Pricing) 123 Tax Notes 959 (May 21, 2009)
37 OECD Review of Comparability and of Profit Methods: Revision of Chapter I-III of Transfer Pricing Guidelines at 4 (Centre for Tax Policy and Administrator, July 22, 2010)
38 Id. at 64-65
39 See supra Transfer Pricing Associates US summary (September 13, 2010)
41 See also John Staples, The US Treasury’s Proposed Section 482 Services Regulations, (BNA, 2004), Reprinted from the January 2004 issue of BNA International’s Tax Planning
Uncontrolled sales for CUP method include (i) Sales made by the taxpayer to an unrelated party, (ii) purchases made by the taxpayer from unrelated parties, and (iii) sales made between two unrelated parties. In *Veritas Software* 42 tax court’s discussion of appropriateness of use of CUT method turns on in their analysis of cost sharing agreement which involved the transfer of “platform contribution” intangibles and broad “make-sell rights” while OEM agreements did not where CUT valuation used as comparables the US company’s agreements with various OEM’s. OEM’s generally undertake manufacturing and production, marketing and distribution, transportation and warehousing activities but do not involve ongoing R&D activities. 43

**US Company with Foreign Subsidiaries**

As between US Parent company (USP) and its wholly owned subsidiary, foreign subsidiary (FS) in non-US site, the US and OECD transfer pricing regulations and guidelines treat USP and FS as independent entities but with allowance for intercompany joint venture (JV) agreement and as such they can act as JV partners. For comparable study, then, USP’s third party JV arrangements with other companies in other foreign soil could be considered in assessing arm’s length division of income as between USP and FS, but IRS tends to reject CUP in the use of JV agreements and instead leans toward residual profit split method. 44 In so far as licensing IP’s to controlled, related group or to its affiliate and as well as to a rival 3rd party, cost of R&D can be either capitalized or amortized over a period of years or to deduct such expenses currently (See 26USC Sec. 174), but Treasury Regulation confines the relevant R&D product in any of the Standard Industrial Classification (SIC) categories 45 and affords both income generating successful R&D as well as the cost of unsuccessful R&D scenarios.” 46

Profits earned by US-owned affiliates in foreign jurisdictions are normally classified as foreign source income. Such income is taxed in the US when distributed as dividends, when included as Subpart F income, or when other income inclusion tax provisions apply. For instance, loans from foreign affiliates characterized as dividend involve a separate foreign tax

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42 *Veritas Software Corporation & Subsidiaries, Symantec Corporation (successor in interest to Veritas Software Corporation & Subsidiaries) v. Commissioner of Internal Revenue*, 2009 US Tax Ct. LEXIS 34; 133 TC No. 14 (December 2009

43 See Treasury Regulation Sec. 1.482-1(d)3(iv), Income Tax Regs., for list of economic condition comparability factors

44 See generally Elizabeth King, Chapter 12, *Transfer Pricing and Corporate Taxation*, (Springer, 2009)

45 See also 26 CFR Sec. 1.861-17(a)(2)(ii) (2002)

46 *Boeing Co. v. United States* 537 US___(2003) at 5 (Slip opinion No. 01-1209)
credit limitation basket and its cost/benefit analysis on loan from Coordination Center may yield zero net benefit for the US as compared with net benefits enjoyed by companies from Japan and Germany under the same analysis.\(^{47}\)

**Foreign Parent Company with US Subsidiary**

Interestingly in *Vitro*\(^{48}\), a recent tax court case, Court held that in so far as guaranty fees associated with a Mexican company, Vitro, foreign parent company that guaranteed debt for its US subsidiary loan, guaranty fees are taxed in Mexico, the source state of income and not as IRS argued as income from US subsidiary thereby assigning it as a US source income subject to tax withholding under Sec. 881(a) IRC. The Court interpreted guaranty as performance on service as oppose to interest normally associated with loan performance and so Court afforded transfer pricing intercompany analysis under Section 482 as being more akin to case at hand than Bank of America Court of Claims case analysis in its interpretation of letter of credit as interest whose characteristic is more routinely in line with loan definition. Court concluded guaranty fee should be sourced to the location of the obligee, that is the guarantor, which in this case is Vitro, a foreign parent company based and operating in Mexico, who will have performed as a secondary loan party for repayment of loan in the event of default of its US subsidiary company in accord with its bylaws enabling parent company to guarantee loans incurred by its subsidiaries.\(^{49}\) Court stated Vitro guaranty fee “was augmenting International’s [US subsidiary] credit, not substituting its own” \(^{50}\) and puts “Vitro’s obligation … [in] entirely secondary” [to loan repayment obligation] to the extent “Vitro did not extend funds to International,”\(^{51}\) and “it is Vitro’s promise and its Mexican assets that produced the guaranty fee.”\(^{52}\)

**APA**

In order to alleviate the uncertainty, cost, and time spent resolving transfer pricing disputes, the United States created the advance pricing agreement process (hereinafter APA) … 

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\(^{47}\) Anthony Billings, Larry Bajor, Al Gourdiji, *Competitive Tax Disadvantages faced by US Multinationals* at 4-7 (Tax Foundation, 1990)

\(^{48}\) *Veritas Software Corporation & Subsidiaries, Symantec Corporation (successor in interest to Veritas Software Corporation & Subsidiaries) v. Commissioner of Internal Revenue*, 2009 US Tax Ct. LEXIS 34; 133 TC No. 14 (December 2009)

\(^{49}\) *Container Corporation, successor to interest of Container Holdings Corporation, successor to interest of Vitro International Corporation v Commissioner of International Revenue*, 134 TC. No. 5 at 31 (Docket No. 3607-05, February 17, 2010)

\(^{50}\) *Id.* at 27

\(^{51}\) *Id.* at 28-29

\(^{52}\) *Id.* at 30
APA is the only way for the tax payer to achieve pricing certainty and penalty avoidance\(^{53}\) [by foregoing opportunity and legal rights to court proceedings to resolve tax disputes.]

Appendix 8 APA Programs in Other Countries (A8-1)\(^{54}\)

<table>
<thead>
<tr>
<th>USA, Hungary, Japan</th>
<th>Spain, South Korea, Australia, Mexico, New Zealand, Canada, Belgium, USA, Hungary, Japan</th>
<th>Kazakhstan, Germany, Netherlands, France, UK, Denmark, China, Ireland, Brazil, Spain, South Korea, Australia, Mexico, New Zealand, Canada, Belgium, USA, Hungary, Japan</th>
<th>Poland, Peru, Colombia, Thailand, Czech Republic, Taiwan, Italy, Venezuela, Kazakhstan, Germany, Netherlands, France, UK, Denmark, China, Ireland, Brazil, Spain, South Korea, Australia, Mexico, New Zealand, Canada, Belgium, USA, Hungary, Japan</th>
</tr>
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</table>

Current APA Focus*

<table>
<thead>
<tr>
<th>Country</th>
<th>Global Documentation Requirements</th>
<th>APA Programs</th>
<th>Current Industry focus</th>
<th>Types of transactions under current scrutiny</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>Contemporaneous documentation required for penalty protection (effective for tax years beginning after December 31, 1993)</td>
<td>Rev. Proc. 2004-40 (unilateral and bilateral)</td>
<td>The communications, technology and media industry groups and retailers, food pharmaceutical and healthcare industry group</td>
<td>LMSB Division’s Tier I and Tier II priority issues include transfer of intangibles, cost sharing arrangements, mixed service costs and post-IRC Sec. 936</td>
</tr>
</tbody>
</table>

\(^{53}\) Kayfetz at 210

\(^{54}\) Levey at 192
<table>
<thead>
<tr>
<th>Country</th>
<th>Global Documentation Requirements</th>
<th>APA Programs</th>
<th>Current Industry focus</th>
<th>Types of transactions under current scrutiny</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>Advance documentation effectively required; documents requested on audit must be provided within 60 days of a request.</td>
<td>Both unilateral and bilateral. The Korean National Tax Service (KNTS) has several structural designs of APA programs.</td>
<td>There is no formal program prioritizing the review of taxpayers in a particular industry or industries.</td>
<td>Tangible goods, IP or intra-group services</td>
</tr>
<tr>
<td>Japan</td>
<td>No statutory requirements, but strongly recommended for audit deferral. Documents commonly requested on audit are noted in Table 1. No contemporaneous documentation obligation.</td>
<td>Both Unilateral and bilateral. The NTA prefers bilateral, generally APA’s for 3 year period) TP Commissioner’s directive (guideline) issued June 1, 2001. TNMM</td>
<td>Automotive and automotive parts, consumer products, pharmaceuticals, medical devices, technology, banking and capital markets and insurance.</td>
<td>Tangible goods (55% caseloads), IP (23%) or intra-group services (20%), financial transactions (e.g., loans, other debt instruments) (2%).</td>
</tr>
<tr>
<td>Country</td>
<td>Global Documentation Requirements</td>
<td>APA Programs</td>
<td>Current Industry focus</td>
<td>Types of transactions under current scrutiny</td>
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</tr>
<tr>
<td>OECD</td>
<td>Pricing decisions should be documented in accordance with prudent business practices. Reasonable for tax authorities to expect tax payer to prepare and maintain such material</td>
<td>most frequently used method in APA’s</td>
<td>Unilateral and bilateral.</td>
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*Extracted from Levey et al. Apendices and Ernest & Young 2009 Global transfer pricing survey.\(^55\)

**Taxpayer’s Burden of Proof in Disputing IRS’s Deficiency Notice**

In the instances where imbalance adjustments were made by IRS in their issuance of a notice of deficiency, it goes without saying that tax penalty and incentives are generally designed to recognize economic values not reaffirm economic realities. In this regard, “taxpayer generally bears a heavier than normal burden of proving that the Commissioner’s Section 482 allocations are “arbitrary, capricious, or unreasonable”,”\(^56\) and also “has the burden of proving satisfaction of the arm’s length standard.”\(^57\) As such, arm’s length standard “to be employed “in every case” to ensure taxpayers accurately reflect income from controlled

\(^{55}\) Levey et al. at 170-194; See also Global Transfer Pricing Survey at 32-38, 53-59, (Ernst & Young, 2009)

\(^{56}\) *DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue*, TC Memo 1998-461 at 22 on LexisNexis print; 1998 Tax Ct Memo LEXIS 461, 76 TCM (CCH) 1122; TCM (RIA) 98461 (December 30, 1998)

\(^{57}\) *Id.* at 30
transactions and do not avoid taxes through such transaction”\(^{58}\) has the effect of assisting fair analysis to decipher the source of income generating activity rather than for the sake of acting as a fair umpire to equalize market competition. “For the purpose of section 482, “control” is broadly defined to include “any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised,” and “the courts look to “reality of control” rather than just to actual stock ownership.”\(^{59}\)

**Intercompany Cost-Sharing Arrangement**

Cost-sharing arrangement (“CSA”) enables parent company to shift income to foreign subsidiaries in a low-tax jurisdiction via joint venture research and development agreements to lower overall tax burden for the corporation as a whole and to avoid having to pay penalty from tax deficiency issuance from IRS for non-compliance of arm’s length price standard which is the underlying principle of IRS Section Code 482 “to prevent tax evasion when a US company shifts income to foreign affiliate, or when the foreign affiliate shifts deductible expenses to the US company by undercharging or overcharging for services, IP or products transferred between the two.”\(^{60}\)

Krutsinger gives an example of CSA scenario.

> In the CSA between A and its foreign subsidiary B “regulations mandate that A’s and B’s expenses to develop and patent the invention must reflect the share of benefits each party expects to receive, or must be proportional to the reasonably anticipated benefits… The benefit of this arrangement is that A does not need to pay US taxes (at 35%) on devices B sells outside the US, and B’s taxes on the income it makes are likely significantly lower than the US tax rate. Additionally, A and B do not have the difficult task of determining an arm’s length royalty rate as would be required if A developed the invention alone and licensed it to B.

> … Typical cost-sharing agreements also involve “buy-in” payments for previously created intangible assets that are used to develop the intangible covered by the CSA. In contrast, a stand-alone CSA does not

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\(^{58}\) Xilinx, Inc. and Consolidated Subsidiaries v. Commissioner of Internal Revenue (9th Cir. 2009) 567 F. 3d 482 at 3 on LexisNexis printout, 2009 US App LEXIS 11118, 2009-1 US Tax Cas. (CCH) P50,405; 103 AFTR 2d (RIA) 2388

\(^{59}\) Supra DHL at 24

\(^{60}\) See generally Krutsinger at 4-5, 9
include terms such as license to pre-existing intangibles. A CSA may also be a “green field” development CSA, in which the parties develop completely new intangible assets rather than building on pre-existing intangible assets. For green field development CSA’s, the cost-sharing transaction is the only transaction relevant in determining whether it is comparable to a CSA between controlled parties.61

In so far as Section 482 regulations as applied to “developer-assister” rule, where allocation is made upon developer’s transfer of property it developed, or an interest in such property based on actual transaction. e.g. patent or copyrights, to a related party in the course of the development of an intangible62 This developer-assister rule applies only “in the absence of a bona-fide cost-sharing agreement satisfying the conditions of the cost-sharing provisions. “Developer” category extends membership to a related-party group undertaking the development of an intangible, that is any member bearing relative cost of development, risks of development whose analysis includes the location of development activities, the capabilities of the various members of the group to perform the development activities, and the degree of control over the project exercised by the various members or simply, in the research and development type activities and the members’ rights and obligations under IP laws.63

Ninth Circuit Court’s decision in Xilinx II64 limits the parameter of CSA in compliance with arm’s length standard of Section 482 as applied to Employee Stock Option (“ESO”) departing from IRS’s interpretation of the “regulation Section 1.482-7A(d)(2)(i) that specifically includes stock-based compensation in operating expenses.”65 Xilinx II opens door to questions on the scope of “what unrelated parties operating at arm’s length would do,” and articulates tension among IRS 2009 cost-sharing regulation, Section 482’s arm’s length standard and international transfer standard in respective contracting states’ tax treaties.66 In an earlier 2000 Tax Court case in Seagate Technology,67 IRS argued that Seagate USP should

61 Krtusinger at 7
63 Id.
64 Xilinx, Inc. and Consolidated Subsidiaries v. Commissioner of Internal Revenue 567 F. 3d 482 at 3 on LexisNexis printout (9th Cir. 2009), 2009 US App LEXIS 11118, 2009-1 US Tax Cas. (CCH) P50,405; 103 AFTR 2d (RIA) 2388
65 Krtutsinger at 35-36
66 Id. at 38
67 See also Seagate Technology v. Commissioner of Internal Revenue, TC Memo. 2000-388 (Docket No. 15086-98, December 22, 2000)
have included in the Cost Sharing Pool the cost of stock options for Seagate FP employees who performed the research and development regarding the intangibles. USP argued that it should prevail under its filing summary judgment motion which states that IRS allocation pursuant to IRC Section 482 should be based on knowledge of arm’s length circumstances where the cost of stock options is shared and IRS replacing and substituting lack of comparables of uncontrolled group with expert testimony relied on hearsay. Court sided with IRS and denied partial summary judgment because of finding of factual dispute.

Comparable Uncontrolled Price (CUP) Analysis pursuant to CSA

In 1994 Seagate Technology, Inc. v. Commissioner of Internal Revenue68 Tax Court detailed reallocations between controlled entities under Sec 482 arm’s length analysis subsequent to operation expansion as a result of a USP based in California formed a FS in Singapore for the purpose of performing component manufacturing. In particular Court analyzed that offset for price allowance computation of “plug” amount to compute Sec. 482 reallocation for the value of services rendered by USP in marketing FS produced part methodology during the early phase of the start-up marketing activities in the Far East was deemed unreasonable and consequently the price allowance not applicable because marketing services can be distinguished from the marketing intangibles USP tapped into when USP transferred bundle of technologies via licensing agreements to FS and there is no showing of overpayment by FS to USP for marketing services.69 Court reasoned in the study of comparables among uncontrolled, unrelated third party group terms of respective licensing agreements “involved different technology, required advance payments [sometimes accompanied by guarantee of the licensees with special rates for specific number of disk drives], provided a cross-license, granted exclusive rights, or contained geographic limitations. Court also noted one reason for inability to assign and quantify relative value of the advance payments, exclusive provisions, and geographic restrictions resulted from lack of methodologies used in support of the assertion for the arm’s length royalty rate range for the same or similar technology. Ostensibly, third party license agreements encompass merely the transfer of technology and know-how relating to applicable products whereas as between USP and FS in question, USP transferred certain valuable marketing intangibles as well as manufacturing intangibles to FS.70

69 Id. at 128-284
70 Id. at 279-281
<table>
<thead>
<tr>
<th>Country</th>
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<th>Global Penalties on Transfer Pricing Assessments</th>
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<tbody>
<tr>
<td>USA</td>
<td>IRS, IRC Sec. 482 (latest amendment effective for tax years beginning after December 31, 1986)</td>
<td>Reg Sec.1.482, Reg Sec. 1.6662-6. IRC Sec 6662(e)-(h)-20% addition-to-tax penalty for substantial valuation misstatements and a 40% addition-to-tax penalty for gross valuation misstatements. IRS’s Transfer Pricing Penalty Oversight Committee</td>
<td>Transfer pricing penalty of 20 or 40 % of additional tax resulting from adjustment exceeding objective thresholds</td>
</tr>
<tr>
<td>South Korea</td>
<td>National Tax Service (NTS), Law for the Coordination of International Tax Affairs (LCITA) (effective January 1, 1996)</td>
<td>Presidential Enforcement Decree, Ministerial Enforcement Ordinance, Basic rulings for LCITA (released in June 2004)</td>
<td>Up to 30MM Won penalty for failure to provide documents in 60 days (one 60-day extension allowed) upon request from NTS. NTS may disregard the documents presented as supporting documents for the tax appeal or CA if the documents were not submitted within 60 days (or 120 days) upon request from NTS without jurisdiction reason. Penalty for understatement is 20 to 30 %, and penalty for underpayment is</td>
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See also Transfer Pricing Country Summaries at [http://www.transferpricing.it/country-summaries.html](http://www.transferpricing.it/country-summaries.html).

Levey et al. at 170-181
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<td>Japan</td>
<td>National Tax Agency (NTA), Special Taxation Measures Law (STML), Article 66-4 (Effective tax years after April 1, 1986)</td>
<td>Enforcement Order 39-12 (partially amended on definition of foreign related parties in March 2005), Enforcement Ordinance 22-10. TP Commissioner’s directive (guidelines) issued on June 1, 2001, partially adjusted June 20, 2002 on intragroup services</td>
<td>No specific transfer pricing penalties for TP. Ordinary penalty is 10 to 15 % of additional tax (35% for concealment of facts). Delinquency tax rate is the lower of 7.3 % and the special discount rate for commercial bill’s at the Central Bank.</td>
</tr>
<tr>
<td>OECD</td>
<td>NA</td>
<td>Transfer Pricing Guidelines Multinational Enterprises and Tax Administration</td>
<td>Notes that civil monetary penalties are frequently calculated as a percentage of the tax understatement, with the percentage ranging from 10 to 20%.</td>
</tr>
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</table>

**Conclusion**

Findings and documentation requirements for IRC Section 482 compliance or tax dispute therein relating to intercompany transfer pricing regulations whose interdisciplinary nature of study in law, economics, accounting and environment that spans state, country and sea borders that monitor business activities in an effort to allocate a share of revenue from income source attributed to any of US territories may be useful for other US government agency research, scrutiny and investigation, including but not limited to casualties capable of repetitions, corruptions, terror activities and holocausts as a matter of equity. As Senator Hubert Humphrey once said which aptly describes this pathos during his campaign trail.

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73 *But see Monsanto Co., v. Geertson Seed Farms. 561US__ (June, 2010) (Slip Opinion, No. 09-475)*
against John F. Kennedy in 1960, “All of history is a constant struggle for emancipation from fears, from tyranny, from ignorance.”\(^\text{74}\)

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About the author:
Dorothy Myung-Soo Hong has been a freelance contract attorney, published author of books and articles and a member of a Chelsea art gallery in New York.

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