US Inbound Corner | Navigating complexity

IRS continues to scrutinize transfer pricing as inbound taxpayers consider their options

The IRS continues to scrutinize the transfer pricing policies of inbound taxpayers by challenging historical losses, methods not based on a targeted net operating profit, and adjustments to take into account the impact of tariffs and COVID-19 on taxpayers' businesses. Recent IRS audit campaigns included an "Inbound Distributor" campaign. Another recent audit campaign, the "Captive Service Provider Campaign," is seemingly more of an issue for outbound taxpayers as it focuses on services fees paid to foreign affiliates of US multinationals; in practice, the IRS is reviewing service fees paid by any US taxpayer (i.e., US multinational or a subsidiary of a foreign multinational) to Indian affiliates, which may impact inbound taxpayers receiving services from such affiliates.

While the transfer pricing policies of many inbound taxpayers involve achieving a targeted level of operating profit, in certain instances the IRS may consider reviewing not only the results of the inbound taxpayer but also the results earned by its related affiliates that are engaged in transactions with the inbound taxpayer (i.e., the IRS may consider the entire system profit). In such instances, the IRS will determine whether a profit split method—a method based on measuring the relative contributions of the parties to the related party transactions—is more reliable than testing the profitability of just one taxpayer. The typical inbound taxpayer profile that the IRS has focused on for applying the profit split method are those taxpayers that both sell consumer products and incur high levels of advertising

In this edition

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Tax News & Views podcasts

Calendars to watch

costs (e.g., foreign auto original equipment manufacturers).

For taxpayers facing IRS audit adjustments for these types of issues, there may be alternatives that avoid litigation to achieve either reduction of the audit adjustment, avoidance of group double taxation, or both. One approach is to take an adjustment to the IRS Appeals office where the taxpayer may achieve a reduction or elimination of the audit adjustment; however, any remaining adjustment may be subject to group double taxation. More frequently, where there is a relevant US tax treaty with a mutual agreement procedure ("MAP") article available, taxpayers will opt for the MAP process to avoid group double taxation. The MAP process involves making formal requests to the IRS and relevant foreign tax authority to resolve the double taxation issue, and then the IRS and its counterpart will negotiate to avoid double tax in most cases.

While the MAP process may resolve years under audit and may cover possibly additional open filed tax years under Accelerated Competent Authority Procedure ("ACAP"), only an advance pricing agreement ("APA") can provide tax certainty for future filed years. The APA process resolves prospective tax years ("APA Prospective Years") and may also include open filed tax years under a rollback ("APA Rollback Years"). In some cases, both MAP and APA requests are filed in order to resolve many years of transfer pricing issues. Further, an APA may provide certainty regarding a tax provision that requires coordination between transfer prices and customs values (i.e., IRC section 1059A). In sum, the MAP and APA processes can be effective procedures to address transfer pricing issues and avoid group double taxation.

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