

Transfer pricing reallocations

Under Section 482 of the Internal Revenue Code, as interpreted by complex regulations, IRS has broad power to reallocate income, deductions and other tax items among commonly controlled businesses to prevent evasion of taxes or clearly to reflect the income of those businesses. IRS is especially alert to situations where it can exercise this power to prevent income from being shifted outside the U.S., but there are also many potential targets involving only domestic businesses. In particular, transactions between a closely-held corporation and its shareholders, or between commonly controlled closely held corporations, may attract IRS scrutiny.

IRS is concerned about these types of transactions because they have the potential to shift income to a person who effectively pays a lower rate of tax. For example, let's say you and members of your family control two closely-held corporations. One, L, has incurred substantial losses while the other, P, is profitable. L supplies P with merchandise and provides services. Since L's profits will not be subject to tax, there is an incentive to increase L's profit at the expense of P by having P pay more for the merchandise it purchases from L so as to reduce P's taxable income.

To prevent related taxpayers from artificially shifting income, an arm's length standard is applied to related company transactions. The pricing won't be adjusted if the results of the transaction are the same as they would have been if the transaction were between unrelated parties under the same circumstances. On the other hand, if a transaction between related parties is priced higher or lower than would have been the case between unrelated parties, IRS can treat it as though it had been on arm's-length terms, and can recharacterize the transaction as appropriate to account for what actually happened. Thus, in the example above where the price is higher than what an unrelated third party would pay, IRS could treat the transaction as though the sales price were on arm's length terms. Thus, P would be treated as paying L a lower price and P's income would be increased and L's income decreased. In addition, if the distortion exceeds certain limits penalties can be imposed.

Regulations provide several methods for determining if pricing is arm's length, depending on the type of transaction involved. All businesses under common control should examine their intercompany pricing policies, and produce careful documentation of the methods used to set intercompany prices to minimize the risk of challenge.

The transfer pricing rules are extremely complicated, and it is often not an easy matter to figure out when and how they apply to specific transactions. IRS has been increasingly aggressive in applying Section 482, and has succeeded in collecting very large sums from major corporations under these rules. We would be happy to go over the rules with you in greater detail, and can help you minimize any potential exposure your related businesses may have. Please contact us to set up an appointment.