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Overview

Covington, Taxand USA

Covington assists taxpayers on a range of transfer pricing issues across our international tax planning and tax controversy practices. Leveraging our strong relationships with transfer pricing economists, we provide advice on transfer pricing aspects of business restructurings, existing trading structures, and financing transactions. We are able to help clients across industries think strategically about their transfer pricing documentation, Country-by-Country Reporting profile, and potential public disclosures, including by developing global transfer pricing audit defense plans. We also have significant experience assisting taxpayers who are under IRS and foreign tax examination and in working with the IRS's Advance Pricing and Mutual Agreement ("APMA") program on Advance Pricing Agreements ("APAs") and Mutual Agreement Procedure ("MAP") matters. Our capabilities include:

- Implementing appropriate intercompany agreements and transfer pricing policies for business restructurings, trading structures, and financing transactions, including strategic consideration of global or specific-jurisdiction transfer pricing policies and related documentation
- Obtaining APAs
- Defending transfer pricing positions in IRS and foreign tax examinations
- Defending transfer pricing positions before IRS Appeals, and if necessary in litigation
- Obtaining MAP assistance under a bilateral tax treaty following transfer pricing adjustments
- Developing plans for tax-related ESG disclosures, such as in connection with public Country-by-Country Reporting

General: Transfer Pricing Framework

Section 482 of the Internal Revenue Code of 1986 (the "Code" or "IRC") allows the U.S. Internal Revenue Service (the "IRS") to adjust the income and deductions of taxpayers under common control as "necessary in order to prevent evasion of taxes or clearly to reflect the income" of such taxpayers. The Department of Treasury ("Treasury") and IRS have published comprehensive regulations under Section 482 adopting the arm's length standard and setting forth applicable transfer pricing methods. The United States has not adopted the Organization for Economic Cooperation and Development ("OECD") Transfer Pricing Guidelines (the "OECD Guidelines"), however the IRS views the Section 482 regulations as "wholly consistent" with the OECD Guidelines.[1] Within the Competent Authority processes, the IRS may refer to the OECD Guidelines; otherwise, the IRS generally enforces transfer pricing rules solely by reference to Section 482 and its regulations and not to the OECD Guidelines.

U.S. taxpayers that are the ultimate parent entities of a multinational group with annual turnover exceeding $850 million USD must file a Country-by-Country Report ("CbCR"). Otherwise, only transfer pricing documentation is required to be prepared or filed. Penalties shall not apply, however, when the taxpayer has prepared transfer pricing documentation compliant with certain regulatory requirements in advance of filing the taxpayer's tax return ("Contemporaneous Documentation"). Contemporaneous Documentation need not be filed with the tax return but must be provided within 30 days of the IRS's request during an audit. A typical transfer pricing audit begins with a request for the taxpayer's Contemporaneous Documentation.

Accepted Transfer Pricing Methodologies

The Section 482 regulations set out specific transfer pricing methods for specific types of transactions. These methods are generally analogous to the methos in the OECD Guidelines. There is no hierarchy of methods. Instead, in all cases, taxpayers must select the "best method" as defined in Treasury Regulation § 1.482-1(c). Selecting the best method depends on the degree of comparability between the controlled transaction or taxpayer and the uncontrolled comparable transaction or taxpayer and on the quality of the data and assumptions used in the analysis.[2]

Treasury Regulation § 1.482-3 sets out the methods available for pricing tangible property transactions as follows: (1) the comparable uncontrolled price method; (2) the resale price method; (3) the cost-plus method; (4) the comparable profits method or CPM (which is generally equivalent to the OECD Guidelines' transactional net margin method, or TNMM); and (5) the profit split method. Treasury Regulation § 1.482-5 contains detailed guidance on applying the CPM, and Treasury Regulation § 1.482-6 contains detailed guidance on applying profit split methods.

Treasury Regulation § 1.482-4 sets out the methods available for pricing transactions involving the transfer of intangible property: (1) the comparable uncontrolled transaction method; (2) the CPM (i.e., TNMM); and (3) the profit split method. Treasury Regulation § 1.482-9 specifies the methods to price services transactions, including (1) the services cost-method, an at-cost safe harbor available in certain circumstances; (2) the comparable uncontrolled services price method; (3) the gross services margin method; (4) the cost of services plus method; (5) the CPM (i.e., TNMM); and (6) the profit split method.

Each type of transaction listed above may also be priced by a method that is not specified in the regulations, which are referred to as "unspecified methods." There are special Contemporaneous Documentation requirements when an unspecified method is chosen.

Treasury Regulation § 1.482-2 provides general principles and a safe harbor for determining the arm's length interest rate for lending transaction, but the regulations do not contain a specific list of methods. Treasury Regulation § 1.482-7 contains rules that apply to cost-sharing arrangements, or CSAs.

[1] Advice Memorandum 2007-007 (March 23, 2007). [2] Treas. Reg. § 1.481-1(c)(2).

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Transfer Pricing Documentation Requirements

The United States implemented a requirement for U.S. ultimate parent entities with annual turnover exceeding $850 million USD to file a CbCR.[3] The United States does not require that taxpayers prepare master or local files, and the United States did not adopt surrogate CbCR filing procedures.

The preparation of Contemporaneous Documentation, which is similar to a local file, is optional. Many U.S. parented multinational groups choose to produce master files due to foreign requirements, and many U.S. taxpayers prepare Contemporaneous Documentation to protect against penalties. Contemporaneous Documentation must be prepared after the end of the tax year in order to test the taxpayer's actual results but before the taxpayer files its U.S. federal income tax return. It is common for the IRS to request a taxpayer's master file and Contemporaneous Documentation, including supporting files, at the start of a transfer pricing audit.

Local Jurisdiction Benchmarks

Taxpayers are required to select and apply the "best method" for transfer pricing purposes based on comparability criteria and available data.

The comparable uncontrolled price ("CUP") method for tangible transactions, the comparable uncontrolled transaction ("CUT") method of intangible transactions, and the comparable uncontrolled services price ("CUSP") method benchmark a taxpayer's transaction to external comparable transactions (i.e., transactions between two third parties) or to internal comparable transactions (i.e., transactions between the taxpayer and a third party). A high degree of comparability is required to apply one of these methods.

Economic comparability factors include the similarity of geographic markets; the relative size of each market, and the extent of the overall economic development in each market; the level of the market (e.g., wholesale, retail, etc.); the relevant market shares for the products, properties, or services transferred or provided; the location-specific costs of the factors of production and distribution; the extent of competition in each market with regard to the property or services under review; the economic condition of the particular industry, including whether the market is in contraction or expansion; and the alternatives realistically available to the buyer and seller. Transactional comparability factors include the form of consideration charged or paid; sales or purchase volume; the scope and terms of warranties provided; rights to updates, revisions or modifications; the duration of relevant license, contract or other agreements, and termination or renegotiation rights; collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and extension of credit and payment terms.

Internal comparable transactions are more commonly used because it is rare to have transactional data for external comparable transactions. However, some accounting firms maintain databases of unrelated licensing transactions that are used as external CUTs.

Certain transfer pricing methods, including notably the CPM/TNMM, require benchmarking based on the profitability of unrelated parties with publicly available financial data. Benchmarking typically emphasizes functional comparability and similarity of economic conditions, based on the economic comparability factors listed above. As a practical matter, there is a preference for using benchmarks that are publicly traded and based in the United States.

Focus on Financial Transactions

Treasury Regulation § 1.482-2(a) governs the transfer pricing for interest payments, applying the arm's length principal. The regulations permit use of interest rates that are between 100% and 130% of the applicable federal rate, or "AFR," as a safe harbor. The IRS publishes AFR tables each month containing the safe harbor interest rates. If the AFR is not used, a benchmarking study is typically performed based on the credit standing of the borrower and any other relevant factors that may affect the interest rate. In 2023, the IRS published a General Legal Advice Memorandum, or "GLAM," stating that the IRS will consider "implicit support" (i.e., support that the borrower may receive from affiliates) in determining the borrower's credit rating and the resulting interest rate for intercompany loans. The IRS's reasoning is that third-party lenders would take into account the borrower's membership in a group in establishing the applicable interest rate. The IRS's position has been heavily criticized, and this issue is currently being litigated before the Tax Court.

The U.S. Treasury Regulations do not directly address guarantee fees, upfront fees, or other types of fees potentially associated with financial transactions.

The transfer pricing regulations only apply to bona fide indebtedness and do not cover the recharacterization of debt as equity. In addition to the transfer pricing rules, there are a number of other U.S. federal income tax considerations related to financial transactions, including the EBITDA-based interest expense limitation under section 163(j), the potential statutory recharacterization of debt as equity under section 385, and the potential for debt to be recharacterized as equity under common law principles.

Advance Pricing Agreement "APA"/Bilateral Advance Pricing Agreement "BAPA" Overview

The IRS's Advance Pricing and Mutual Agreement ("APMA") office administers a robust APA program. APMA encourages bilateral APAs to unilateral ones. Multilateral APAs are available but rare. Since the inception of the U.S. APA program, over 2,500 APAs have been concluded. Around 150 APAs were concluded in each of 2023 and 2024. In 2024, the most common countries for U.S. bilateral APAs were India,

[3] Treas. Reg. § 1.6038-4.

Japan, Italy, Canada, Korea, and Mexico. Renewal APAs are often about half of those concluded in a given year.

Revenue Procedure 2015-41 sets out detailed procedural requirements for APA applications. The Revenue Procedure sets forth the specific contents of an APA request and the required exhibits, unless permission to submit an abbreviated APA request is obtained. The IRS is in the process of revising and updating this revenue procedure. In addition, in 2023, the IRS released new APA intake procedures that place emphasis on the pre-filing process. The pre-filing process is strongly encouraged in most caess.

As of January 1, 2024, the following filing fees apply to U.S. APA requests:

- Original APA: $121,600
- Renewal APA: $65,900
- Small Case APA: $57,500
- APA Amendment: $24,600

On average, a unilateral APA takes approximately 2 to 2.5 years from filing to conclusion. On average a new bilateral APA takes 3.5 to 4 years to complete, and a renewal bilateral APA takes 2.5 to 3 years to complete.

Transfer Pricing Audits

Transfer pricing is regularly audited by the IRS, and the IRS has published a formal Transfer Pricing Examination Process ("TPEP") that it follows for these audits. Transfer pricing audits are typically staffed by a tax law specialist and an economist, among other IRS audit team members. Audits typically commence with a request for the taxpayer's Contemporaneous Documentation, followed by a request for supporting files, and progress through a series of Information Document Requests ("IDRs"). Fact finding can be extensive, and the IRS has very broad statutory powers to request information relevant to the taxpayer's tax liability. In transfer pricing audits, it is common for the IRS to request information such as job descriptions and organizational charts. The IRS may also request employee evaluations or broad categories of SAP data. Significant transfer pricing audits often include functional interviews, which are conducted under penalties of perjury by the IRS.

The Burden of Proof in Transfer Pricing: Theory versus Practice

Taxpayers generally have the burden of proving their tax positions, particularly their entitlement to tax deductions. In practice, transfer pricing audits often involve significant fact-finding. It is common for the IRS to conduct factual interviews of multiple employees in both the United States and the counterparty jurisdiction in order to verify the taxpayer's stated functional analysis. It is not uncommon for the IRS to request to review personnel files, such as job descriptions and performance reviews, as a part of its functional analysis

Transfer Pricing Penalties

Under Code Section 6662, the IRS may impose penalties on either a transaction-by-transaction basis or on the basis of net adjustments to a taxpayer's income for a given taxable year resulting from section 482 allocations. With respect to particular transactions, a 20% penalty applies if the price reported on a return is 200% or more, or 50% or less, of the amount determined to be the correct price under Section 482. The penalty increases to 40% if the price claimed on a return is 400% or more, or 25% or less, of the amount determined under Section 482. With respect to penalties imposed on the basis of net section 482 adjustments for a given taxable year, a penalty of 20% applies if the net section 482 adjustments exceed the lesser of $5 million or 10% of the taxpayer's gross receipts. The penalty for net section 482 adjustments increases to 40% if the adjustments exceed the lesser of $20 million or 20% of the taxpayer's gross receipts. Preparing Contemporaneous Documentation that meets regulatory requirements generally provides a taxpayer with a defense to penalties.

In recent years, the IRS has increased its efforts to assert penalties in connection with Section 482 adjustments, including in cases where the taxpayer has prepared Contemporaneous Documentation. For example, in 2018, the IRS issued a directive encouraging the assertion penalties in the transfer pricing context where appropriate, reasoning that if penalties are not applied, the IRS will be failing to make adequate use of a legislative tool intended to encourage taxpayer compliance.

Local Hot Topics and Recent Updates

In many cases involving the choice of method, the taxpayer has used a comparable uncontrolled transaction or profit split to allocate a significant return to a foreign related party and the IRS has asserted that the foreign related party should be tested using the CPM/TNMM.

A taxpayer successfully challenged the IRS's "blocked income" regulations, which require transfer pricing adjustments that take into account foreign earnings even when there are foreign legal restrictions that prevent the actual payment of the funds

In 2025, the IRS Chief Counsel's office released a general legal advice memorandum outlining its position on the "commensurate-with-income" standard, or "CWI." The IRS views itself as having the authority to adjust the pricing of transactions involving the sale of an intangible based on the income derived from the intangible by the purchaser, absent the application of a specific regulatory exception. In the memorandum, IRS Chief Counsel asserted that a taxpayer cannot overcome such adjustments merely by showing that it satisfied the best method rule when pricing the transaction. This policy represents a shift from the IRS's previously established position that it would not make ex-post periodic adjustments to income attributable to transfers of intangibles based on actual income realized.

In 2025, Facebook's parent company, Meta, filed a Tax Court petition challenging a CWI adjustment asserted by the IRS.

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Documentation threshold

Master file	No Requirement
Local file	No Requirement
CbCR	Ultimate Parent Entity with $850,000,000 in revenue during the prior reporting period

Submission deadline

Master file	No Requirement
Local file	No Requirement
CbCR	Tax Return Filing Date for Ultimate Parent Entity

Penalty Provisions

Documentation – late filing provision	No Requirement
Tax return disclosure – late/incomplete/no filing	No Requirement. Failure to provide adequate disclosure of certain positions exposes taxpayers to the risk of imposition of certain accuracy-related and other penalties under the Code.
CbCR – late/incomplete/no filing	A penalty of $10,000 may be imposed for failure to file a CbCR, with the penalty increasing by $10,000 for each thirty-day period the return is not furnished, up to a maximum of $50,000 annually. The increases begin 90 days after the IRS notifies the taxpayer of the failure to file.

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