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Accounting Policy & Practice Portfolios: Accounting for Income Taxes
Portfolio 5004-2nd: Accounting for Income Taxes: Uncertain Tax Positions in Transfer Pricing
Portfolio Description

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This Portfolio revises and supersedes 5004 T.M., *Accounting for Income Taxes: Uncertain Tax Positions in Transfer Pricing*. Portfolio 5004 T.M. should be discarded.

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PORTFOLIO DESCRIPTION —

Tax Management Portfolio, *Accounting for Income Taxes: Uncertain Tax Positions in Transfer Pricing*, No. 5004-2nd, provides an overview of the process required under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740-10 (formerly FASB Interpretation No. 48 (FIN 48)) and its application to transfer pricing. The purpose of the ASC 740-10 process with respect to transfer pricing is to quantify the tax reserve that may be required due to the uncertainty related to a transfer pricing position and its reflection in the financial statements of a multinational enterprise (MNE).

The first part of the Portfolio discusses ASC 740-10 and its application to transfer pricing, including a brief overview of the transfer pricing regulatory environment. The second part of the Portfolio summarizes the identification and documentation of uncertain tax positions with respect to transfer pricing, including the relative importance and unique aspects of transfer pricing positions. The third part of the Portfolio explains the recommended approach to determining the Unit of Account for a transfer pricing position and applying initial filters. The fourth part of the Portfolio covers evaluating the arm's length nature of intercompany pricing, specifically, key considerations when evaluating transfer pricing exposures. The fifth part of the Portfolio discusses the recognition of uncertain tax positions related to transfer pricing. The sixth part of the Portfolio explains ASC 740-10's measurement requirements; how to identify information relevant to analyzing potential exposure; use of and framework for a preliminary test; and defining scenarios for transfer pricing. The seventh and final Section discusses disclosures in detail, particularly, interest and penalties; tabular reconciliations, quarterly and annual disclosures; "early warning" disclosures; the impact of court decisions; and compliance considerations.

This Portfolio may be cited as Dicker, Sanborn, and Schuette, 5004-2nd T.M., *Accounting for Income Taxes: Uncertain Tax Positions in Transfer Pricing*.

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I. Overview of ASC 740-10 and Its Application to Transfer Pricing

Section I of this Portfolio describes the key aspects of the two-step process required under Financial Accounting and Standards Board (FASB) Accounting Standards Codification (ASC) 740-10 and how transfer pricing-related tax positions give rise to ASC 740-10 considerations requiring special attention.

A. Scope and Purpose of ASC 740-10

ASC 740-10 belongs to guidance compiled under U.S. Generally Accepted Accounting Principles (U.S. GAAP) that outline accounting rules used to prepare, present, and report financial statements for corporations in the United States. The U.S. Securities and Exchange Commission (SEC) requires that financial statements of U.S. companies listed on U.S. stock exchanges be prepared in accordance with U.S. GAAP,[1] but U.S. GAAP is also used by a wide variety of unlisted entities. The FASB is the institutional body with the highest authority in establishing U.S. GAAP rules and is tasked with providing timely guidance to public companies, accounting firms, regulators, and others on accounting issues that are determined to be of immediate significance to investors.[2] ASC 740-10, therefore, applies to all companies, both public and private, that prepare financial statements under U.S. GAAP.

[1] Securities Exchange Act, §13(b), 15 U.S.C. §78m(b)(2)(B)(ii) and 78(i). *See also,* 17 C.F.R. §210.4-01(a)(1) (which states that the SEC will presume that financial statements filed with it that are not prepared according to GAAP are misleading or inaccurate, despite footnotes or other disclosures). While this Portfolio is intended to provide authoritative information regarding the subject matter covered, it is not intended to provide legal or accounting advice or any other professional service. The information is not relevant for any particular client or use and may not reflect all relevant laws applicable to any particular factual situation. Although diligent effort has been made to ensure accuracy of the information, the authors and publisher assume no responsibility for any reader's reliance on the information or opinions expressed herein, and encourage the reader to verify all items by reviewing the original sources. To ensure compliance with IRS requirements, any discussion of U.S. federal tax matters contained in the publication is not intended or written to be used, and cannot be used, for (i) avoiding tax penalties that may be imposed on the recipient or any other taxpayer, or (ii) promoting, marketing or recommending to another party any arrangement or other transaction addressed herein.

[2] *See* SEC Release No. 33-8221, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter* (Apr. 25, 2003).

The concepts within ASC 740-10 that are the focus of this Portfolio originated from FASB Interpretation No. 48, *Accounting for Uncertainty in Income Tax Positions — An Interpretation of FASB Statement No. 109* (FIN 48) and FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109).[3]

[3] FIN 48 was a supplement to FAS 109, which was the precursor to ASC 740. In 2009, FASB took the various guidance issued on the accounting for income taxes on an entity's financial statements over the years, along with FASB pronouncements, emerging issues task force papers, etc., and combined them under ASC 740. ASC 740-10 is the subheading under which the uncertainty provisions of FIN 48 were codified. Therefore, for this Portfolio, we will solely be referencing the appropriate ASC 740-10 regulations and guidance thereunder.

One of the purposes behind the requirements of ASC 740-10 was stated in paragraph 2 of FIN 48:

> … this Interpretation clarifies the application of [Statement of Financial Accounting Standards No. 109 (FAS 109)] by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. Additionally, this Interpretation provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

FAS 109 provided guidance on accounting for income taxes; however, this statement did not clarify how to treat uncertainties related to income tax, such as litigation outcomes, audit settlements, and other contingencies. Prior to the issuance of FIN 48 , contingent liabilities, including tax liabilities, were accounted for under FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5). FAS 5 defines concepts of "probable," "reasonably possible" and "remote" to describe the chance of future events occurring. Under this standard, a company's assignment of these terms to income tax positions determined whether that position would be disclosed or accrued in its financial statements.

In support of the development of FIN 48, FASB cited inconsistencies in the way companies implemented FAS 5. Specifically, the summary preceding FIN 48 stated:

> Statement 109 contains no specific guidance on how to address uncertainty in accounting for income tax assets and liabilities. As a result, diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.[4]

[4] FASB Interpretation No. 48, *Accounting for Uncertainty in Income Tax Positions—An Interpretation of FASB Statement No. 109* (June 2006).

To eliminate inconsistencies perceived by FASB to be made in the way companies implemented FAS 5, FIN 48 introduced a framework for analyzing uncertain tax positions and described a two-step process under which all such positions are examined, a process which is now incorporated into ASC 740-10. The details of ASC 740-10's requirements are explained in later subsections, but in general, ASC 740-10 requires that companies perform the following for all tax positions under the scope of FAS 109:

1. Define a Unit of Account by which to analyze each tax position.[5]

[5] *See* ASC 740-10-25-13.

2. Subject each tax position (as described in terms of the identified Unit of Account) to a Recognition test, whereby the financial statement effects from that position may only be recognized when it is more likely than not (MLTN), defined as a likelihood of more than 50 percent, that the position will be sustained upon examination by the tax authority.[6] Note that this step assumes that the position will be examined.[7] The Recognition determination must be made based on the technical merits of the position, and the company cannot consider offsets or aggregations with other positions.[8] Special rules are also stated for subsequent recognition,[9] derecognition,[10] and measurement of tax positions.[11]

[6] ASC 740-10-25-6.

[7] ASC 740-10-25-7(a).

[8] ASC 740-10-25-7(b).

[9] ASC 740-10-25-8.

[10] ASC 740-10-40-2.

[11] ASC 740-10-35-2.

3. Measure all tax positions that pass the Recognition test (i.e., meet the MLTN threshold) as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon effective settlement with a tax authority that has full knowledge of all relevant information.[12]

[12] ASC 740-10-30-7.

4. Prepare certain disclosures.[13]

[13] ASC 740-10-50-15, 15A, subject to transition guidance 740-10-65-9.

There are also several specific rules for the treatment of interest, penalties, classification of liabilities recognized from applying ASC 740-10 and other related items.[14]

[14] *See* ASC 740-10-45.

FASB noted that this process and the guidance contained within ASC 740-10 was intended to ameliorate the issues encountered under FAS 5 as follows:

> This Interpretation [FIN 48] will result in increased relevance and comparability in financial reporting of income taxes because all tax positions accounted for in accordance with Statement 109 will be evaluated for recognition, derecognition, and measurement using consistent criteria. Finally, the disclosure provisions of this Interpretation will provide more information about the uncertainty in income tax assets and liabilities.[15]

[15] *Summary of Interpretation No. 48,* FASB, *available at* www.fasb.org.

The common practice of netting the tax liability for several tax positions against each other is no longer allowed under ASC 740-10, which now requires taxpayers to evaluate each tax position separately.

Additional details on the history behind ASC 740-10 can be found in 5001 *Accounting for Income Taxes: Fundamental Principles and Special Topics* (Accounting Policy and Practice Series).

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B. Transfer Pricing and ASC 740-10

FASB wrote the requirements of ASC 740-10 to apply to all tax positions, including transfer pricing.[16] Transfer pricing refers to the pricing of an organization's intercompany transfers of tangible goods, intangible property, services, or financial instruments across borders. These transfers are generally subject to specific tax requirements. To determine whether transfer pricing results in an identifiable tax position, one refers to the ASC Master Glossary definition of “tax position” referenced in ASC 740-270-20, which states:

[16] *See* ASC 740-10-55-101.

> A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term *tax position* also encompasses, but is not limited to:
>
> a) A decision not to file a tax return
>
> b) An allocation or a shift of income between jurisdictions
>
> c) The characterization of income or a decision to exclude reporting taxable income in a tax return
>
> d) A decision to classify a transaction, entity, or other position in a tax return as “tax exempt”

e) An entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity

Item b) relates to the intercompany pricing of a transaction between tax jurisdictions, which results in an allocation of income between those jurisdictions. The example below illustrates this point in greater detail:

Example: How Transfer Pricing Can Result in an Allocation of Income Between Jurisdictions

Consider a multinational enterprise (MNE) that has a manufacturer in one tax jurisdiction selling its entire product to a related-party distributor located in another tax jurisdiction. Assume that the distributor's cost of goods sold (COGS) entirely consists of the purchases from its related-party manufacturer.[17]

[17] For simplicity, assume that the distributor sells everything it buys from the manufacturer instantly, so that its COGS consist of the purchases from its related-party manufacturer during the relevant period. There are no additions to inventory.

Scenario 1:

	Manufacturer	$200 → Distributor	Consolidated
Revenues	$200	$240	$240
COGS	150	200	150
Operating Expenses	20	10	30
Taxable Income	$30	$30	$60
Tax Rate	*10%*	*40%*	*25% ETR*
Taxes Paid	$3	$12	$15

In Scenario 1, the manufacturer charges the distributor $200 for goods. If the manufacturer has COGS of $150 and operating expenses of $20 (total costs of $170), it will have $30 of taxable income. The tax rate in the country in which the manufacturer is incorporated is 10 percent, resulting in $3 in taxes paid.

The distributor's profit and loss statement is made up of $240 in third-party revenue, $200 in related-party COGS, and an additional $10 in operating expenses. In total, the distributor earns $30 of profit. The tax rate in the country in which the distributor is incorporated is 40 percent, resulting in $12 in taxes paid.

In Scenario 1, the MNE pays a total of $15 in taxes. Since the total taxable income of the group is $60, this represents an effective tax rate of 25 percent (i.e., $15 in taxes paid divided by $60 of taxable income). Now consider Scenario 2.

Scenario 2:

	Manufacturer	$220 → Distributor	Consolidated
Revenues	$220	$240	$240
COGS	150	220	150
Operating Expenses	20	10	30
Taxable Income	$50	$10	$60
Tax Rate	*10%*	*40%*	*15% ETR*
Taxes Paid	$5	$4	$9

In Scenario 2, the manufacturer charges the distributor $220 for the goods rather than the $200 charged in Scenario 1. The change in price has a significant effect on total taxes paid because of the varying tax rates in the two jurisdictions. Specifically, because the manufacturer now receives $220 in revenue rather than the $200 it earned in Scenario 1, its taxable income increases by $20, to $50. Applying the 10 percent tax rate results in $5 in taxes paid. On the other side of the transaction, the distributor's taxable income has decreased by $20 because of the increase in its COGS. This results in taxable income of $10, which, after applying the 40 percent tax rate, results in $4 in taxes paid by the distributor.

On a consolidated basis, the MNE's revenues, COGS, operating expenses and taxable income remain identical to the corresponding amounts in Scenario 1. However, because profit has been shifted from the higher tax jurisdiction into the lower tax jurisdiction, the MNE has saved $6 in taxes ($15 less $9), and the overall effective tax rate has been reduced from 25 percent to 15 percent.

This example illustrates how an MNE's transfer pricing allocates income between jurisdictions and how this allocation affects the company's overall effective tax rate.

Acknowledging transfer pricing's impact on taxable income, jurisdictions around the world have enacted transfer pricing regulatory frameworks to regulate this activity. For example, in the United States the Internal Revenue Service (IRS) is granted authority under the Internal Revenue Code to reallocate income as follows:

Sec. 482. Allocation of income and deductions among taxpayers:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer of the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.[18]

[18] Internal Revenue Code §482, as applied to transfers in taxable years beginning after 2018, as revised under Internal Revenue Manual, Part 4, Section 5 (Allocation of Income and Deductions Under IRC 482), dated Nov. 19, 2019. Unless the context indicates otherwise, all "§" references are to the U.S. Internal Revenue Code (the Code), and all "Reg. §" references are to the regulations issued thereunder (and set forth in 26 CFR).

Similar rules exist in jurisdictions all over the world. Whether or not a taxpayer and a tax authority agree on the appropriateness of the taxpayer's allocation of income across jurisdictions is an uncertainty that is generally resolved after the taxpayer files its tax return for a particular period.[19] Therefore, transfer pricing inherently creates tax positions that are uncertain and, thus, within the scope of ASC 740-10.

[19] An exception to this occurs when the taxpayer has entered into a bilateral Advance Pricing Agreement with the tax authorities on both sides of the intercompany transaction. In that case, the uncertainty of a transfer pricing position is largely removed for the tax years the Advanced Pricing Agreement is in place. Section IV.B.5. of this Portfolio discusses this further.

C. Entities Requiring ASC 740-10 Analyses of Transfer Pricing-Related Tax Positions

Any public or non-public company that prepares financial statements according to U.S. GAAP is affected by ASC 740-10 and any MNE that has taken a position on a tax return that is affected by intercompany pricing will need to analyze its transfer pricing positions using ASC 740-10. An MNE may not necessarily have any ASC 740-10 reserves or quantifiable effect on its financial statements based on the analysis, but the group's auditors will want to know that uncertain tax positions caused by transfer pricing-related issues were considered in the preparation of its ASC 740-10 analysis.

D. Summary of Transfer Pricing Regulatory Environment

As demonstrated in the example in Section I.B. of this Portfolio, an MNE could structure its transfer prices to minimize its overall effective tax rate by re-allocating a non-arm's length amount of income into tax jurisdictions. Tax authorities in most tax jurisdictions have adopted transfer pricing rules that require MNEs to price their intercompany transactions on an arm's length basis, that is, as if they were transacting with an unrelated third party. These rules restrict taxpayers' ability to either understate or overstate transfer prices, and they grant tax authorities the right to adjust the taxable income of a taxpayer that violates the jurisdiction's transfer pricing requirements. In many cases these regulations are accompanied by documentation requirements and penalty provisions for non-compliance. Example I.B. of this Portfolio demonstrates the effect of an MNE structuring its transfer prices in a non-arm's length manner by over-allocating income into a low-tax jurisdiction.

U.S. transfer pricing rules refer to the arm's length standard as the standard to which intercompany transactions must adhere. In most other tax jurisdictions, the standard is based on the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines and is called the "arm's length principle."[20] However, both terms reflect the concept that the appropriate price for a controlled transaction is the price that would have been charged for the same transaction if it had been executed between two unrelated parties. The concept, first introduced in the United States in 1936,[21] was incorporated into the OECD's Model Tax Convention in 1963 and adopted by the United Nations in 1980 in its Model Double Taxation Convention between Developed and Developing Countries.[22] Formal transfer pricing guidelines incorporating the arm's length principle were first approved by the OECD in 1995, and have been updated regularly since. They have been adopted by most tax jurisdictions other than the United States.[23]

[20] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022,* OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en, p. 19. The OECD comprises 38 member countries that work together, in part, to coordinate domestic and international policies. Note however jurisdictions may localize and adjust certain aspects of the rules they adopt from the OECD Guidelines.

[21] Art. 45-1(b) of Reg. 86 (1935) (Revenue Act of 1934).

[22] Written contribution to the Conference "Alternative Methods of Taxation of Multinationals" (13–14 June 2012, Helsinki, Finland) by Marlies de Ruiter, Head of the Tax Treaty, Transfer Pricing and Financial Transactions Division, Centre for Tax Policy and Administration, OECD. https://www.taxjustice.net/cms/upload/pdf/Marlies_de_Ruiter_1206_Helsinki_text.pdf.

[23] For a detailed discussion of the OECD transfer pricing regulations, including their relationship with the U.S. regulations, see 6936 T.M., *Transfer Pricing: OECD Transfer Pricing Guidelines.*

The current IRS definition of the arm's length standard, largely unchanged from 1936, is contained in Reg. §1.482-1(b)(1):

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

The OECD Transfer Pricing Guidelines quote Article 9 of the OECD Model Tax Convention to describe the arm's length standard as follows:

> [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial

> relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[24]

[24] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022,* OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en., ¶1.6.

The arm's length standard relies on the existence of independent third-party comparables. This raises practical issues, since in many cases the facts and circumstances of a related-party transaction are not replicated in market transactions. This is a particularly common problem when the intercompany transactions involve valuable intangible property, as intangibles inherently have unique characteristics. Even when comparable uncontrolled transactions exist, the data needed to observe pricing for such transactions is often difficult to obtain.

Most countries' transfer pricing regulations (and the OECD's) outline various transfer pricing methods available to taxpayers when applying the arm's length standard.[25] Specifically, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

[25] For a detailed discussion of transfer pricing methods see 6936 T.M., *Transfer Pricing: OECD Transfer Pricing Guidelines,* III and 6912 T.M., *Transfer Pricing: A Case Study (Methods and Documentation).*

Evaluating whether a controlled (i.e., intercompany) transaction produces an arm's length result is made pursuant to a particular transfer pricing method. Companies must determine which method is most appropriate for the intercompany transaction under review. This determination is generally based on their assessment of the degree of comparability between the tested intercompany transaction and any uncontrolled comparables or transactions available pursuant to that method, as well as the quality of the data and assumptions to be used under that method. More information regarding selection of transfer pricing methods is found in Section VI.D. of this Portfolio.

The U.S. transfer pricing regulations recognize that application of a transfer pricing methodology may not yield a unique measure of an arm's length result. Therefore, the regulations include the concept of the arm's length range.

> In some cases, application of a pricing method will produce a single result that is the most reliable measure of an arm's length result. In other cases, application of a method may produce a number of results from which a range of reliable results may be derived. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).[26]

[26] Reg. §1.482-1(e)(1).

The OECD Transfer Pricing Guidelines also recognize the potential lack of precision in the application of transfer pricing methodologies, and therefore that an arm's length range may be appropriate.

> In some cases it will be possible to apply the arm's length principle to arrive at a single figure (e.g., price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable.[27]

[27] OECD Transfer Pricing Guidelines, ¶3.55.

The use of inexact comparables requires judgment over what comparables are useable and what comparables are too inexact to be relied upon. In addition, the selection of one transfer pricing method over another depends partly on the assessment of relative comparability and quality of data. This decision-making is necessarily subjective and can lead to different results. For this reason, transfer pricing is often a significant source of controversy and dispute between taxpayers and tax authorities. Items recorded on a tax return that relate to income or expense attributable to intercompany transactions may therefore be disputed upon audit.

II. Identifying and Documenting an Uncertain Tax Position Related to Transfer Pricing

Unlike a formula-based rule, the arm's length standard can lead to differences of opinion on the correct arm's length result, especially since identical comparables rarely exist. All of this introduces judgment, and with it, differences of opinion that can lead to disputes. Therefore, uncertainties are inherent in transfer pricing which lead to unique considerations in identifying and documenting uncertain tax positions related to transfer pricing, as discussed in the subsections below.

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II. Identifying and Documenting an Uncertain Tax Position Related to Transfer Pricing

A. Uncertainties Inherent in Transfer Pricing-Related Tax Positions

For any particular intercompany transaction involving related parties in Country A and Country B, there are three potential conflicting perspectives: (1) the tax authority in Country A; (2) the tax authority in Country B; and (3) the taxpayer. Even if Country A and Country B both follow the OECD Transfer Pricing Guidelines, their interpretation of the OECD Transfer Pricing Guidelines may give rise to transfer pricing conflicts. There can be disputes over the choice of methodology to evaluate an intercompany transaction, or over the choice of comparables, or over any number of decisions made in the application of a methodology. The examples below illustrate these concepts.

- **Example 1 — Disagreements over method selection.** Different jurisdictions apply different standards for evaluating comparability and the relative reliability of transfer pricing methods. For example, it is very common for tax authorities to dispute whether a particular uncontrolled transaction is sufficiently comparable to be used under a transactional transfer pricing method, such as the IRS's Comparable Uncontrolled Transaction (CUT) method when dealing with the transfer of intangibles. These differences can lead to situations where one tax authority believes that the CUT method can be applied and another believes that a profits-based method, such as the Comparable Profits Method (CPM),[28] would give a more reliable measure of an arm's length result.

[28] Under the OECD Transfer Pricing Guidelines, the TNMM is analogous to the CPM specified under the US Transfer Pricing Regulations.

- **Example 2 — Disagreements over comparables.** Similar to the situation described in Example 1 above, differing ideas about standards of comparability could yield different applications of the same method (i.e., alternative applications of a CPM) by applying data from different comparables. Even though the parties may agree about the selected method, disagreements about which comparables are appropriate could result in different conclusions about the arm's length range and the most appropriate result.

- **Example 3 — Determinations regarding the ownership of valuable intangibles.** The question of whether an entity owns valuable non-routine intangibles, and the value associated with it, generates a significant number of transfer pricing disputes. A legal entity that owns valuable non-routine intangibles generally warrants compensation that is subject to more volatility (and often has a higher remuneration) than a legal entity that does not own such intangibles. If ownership of intangible property is disputed, the parties involved will likely disagree over the appropriate transfer price for transactions that involve such intangible property. Similar disagreements often arise as to whether a non-routine intangible actually exists. For example, the tax authorities may argue that the taxpayer's marketing function creates a marketing intangible, while the taxpayer has taken the position the marketing function is providing only routine marketing services that would be expected to be generated over the normal course of business, and no non-routine intangible (for which a non-routine return is warranted) has been created.

- **Example 4 — Disagreements over benefits received from, and quantification and deductibility of, service charges and intercompany interest.** Intercompany service charges generate significant controversy and disputes. Unlike intercompany transfers of tangible property, which are visible and relatively obvious transfers of value, an MNE's assertion that services are rendered by one entity on behalf of another in another jurisdiction is difficult for external parties to ascertain. In the context of transfer pricing, whether an intercompany service requires a charge is determined by whether the entity on the receiving end of the service derives a direct benefit from that service. The derivation of benefit may be determined under local country law, which can vary in application. Tax authorities may dispute the price charged for an intercompany service, or even deny the deductibility of the entire charge on the grounds that measurable benefits are not received. Similarly, for intercompany financing or loan activities, tax authorities may dispute the characterization of the transaction (e.g., whether the loan qualifies as debt or equity) and associated deduction of interest expense.

These are just a few examples of circumstances related to different interpretations of critical facts that guide transfer pricing analyses and that could generate transfer pricing disputes.

In addition, different countries can adopt the OECD Transfer Pricing Guidelines in slightly different ways. For example, the Guidelines allow for an arm's length range as described above. However, the definition of this range may vary between jurisdictions. Some countries' transfer pricing regimes refer to the full range of results as the arm's length range,[29] while others emphasize the use of a statistically narrowed range such as an interquartile range.[30] As a result, a taxpayer's intercompany price that falls within one range of results as defined by one jurisdiction but not in the range defined by the counterparty may find itself in the middle of a transfer pricing dispute between the two jurisdictions.

[29] For example, the Canada Revenue Agency (CRA) uses the single-year full range of results when referring to the arm's length range.

[30] Different countries may define the interquartile range differently. For example, in India, the interquartile range is understood to represent the 35^{th} – 65^{th} percentile, while the United States and many other countries define the interquartile range as the 25^{th} – 75^{th} percentile. Furthermore, even in instances in which the interquartile range is defined as encompassing the same percentiles, the calculation of those percentiles may also differ.

Comment: Transfer pricing is inherently uncertain, partly because it is based on a factual assessment of the transaction (not a quantitative one), and partly because it requires decision-making using the judgment of tax professionals rather than a fixed formula. ASC 740-10 analyses, therefore, must address tax positions related to transfer pricing, and reporting entities must account for the uncertainties in a way that satisfies the provisions of ASC 740-10.[31]

[31] The Advance Pricing Agreement (APA) program, implemented by many major tax authorities, is designed to prevent transfer pricing disputes and provide certainty to the taxpayer. As an example, consider a taxpayer with an intercompany license of intangibles between the U.S. parent and its U.K. subsidiary. The taxpayer applies for and successfully concludes a bilateral APA with both tax authorities governing the transaction (i.e., IRS and HRMC) for the pricing of the transaction at a royalty of 3.5 percent of Net Sales for a period of five years. During that five-year period, as long as the taxpayer abides by the terms of the APA agreement (including application of the agreed methodology and compliance with all the critical assumptions enumerated in the APA), the taxpayer is guaranteed certainty for that tax position, which would then not be subject to the provisions of ASC 740-10.

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B. Identification of Transfer Pricing-Related Uncertain Tax Positions

To identify all intercompany transactions within all relevant jurisdictions, an entity must have a thorough and systematic process for capturing data from multiple sources. Listed below are several sources for identifying transfer pricing Uncertain Tax Positions (UTP).[32]

[32] While not specifically defined under ASC 740, for the purposes of this Portfolio the use of the term “UTP” is meant to encompass the uncertainty(ies) of a tax position when evaluating the difference between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to Subtopic 740-10, unless explicitly noted otherwise (referred to under ASC 740-10-20 as an “unrecognized tax benefit”).

1. U.S. Forms 5471 and 5472 as well as foreign tax forms for disclosing intercompany transactions
2. Internal ledgers and reports within a company's ERP system or other financial systems that provide details on intercompany accounts
3. Intercompany agreements
4. Transfer pricing manuals
5. Previous transfer pricing audit workpapers and correspondence
6. Transfer pricing documentation reports

A systematic review of these sources can assist in developing a comprehensive list of all relevant intercompany transactions that must be identified under ASC 740-10. It is important not only to identify intercompany transactions for which an intercompany charge was recorded, but also to identify transactions for which a charge *should* have been recorded but was not. A lack of a charge when one was warranted can create a large potential exposure (including significant penalties) and should be counted among the UTPs considered in the ASC 740-10 analysis.

Comment: It is common to find transactions that are not recognized. To ensure a comprehensive list of all relevant intercompany transactions that must be identified under ASC 740-10, it is important to have conversations with a taxpayer's management (especially those involved in operations), the tax team, and other relevant parties to identify all intercompany transactions, including those that are not being recognized or reported (but should be). Furthermore, the importance of mitigating risk of unrecognized transactions points to the importance of conducting functional analyses and fully understanding the business context to identify potential transactions that are not found in the data.

C. Relative Importance of Transfer Pricing in Determining Uncertain Tax Positions

The uncertainty inherent in transfer pricing-related tax positions can have a significant impact on ASC-740 analyses and the identification of a company's uncertain tax positions that need to be accounted for. Recent developments around global tax reform and the inherent uncertainty in transfer pricing-related tax positions have increased companies' concerns around double taxation, effective tax rate instability, and business volatility.[33] In addition, the 2022 *Global MNC Tax Complexity Survey*, published by Accounting for Transparency, found participants identified transfer pricing as the most complex regulations of the tax code for multinational corporations in 65 of 95 countries.[34] To the extent a multinational operates in jurisdictions with widely varying tax rates, different intercompany pricing policies can have significant implications on its global tax burden. The potential for double taxation (discussed further in IV.B.4., below), penalties and interest, and reputational consequences because of transfer pricing disputes could have a material adverse effect on the financial performance of a multinational corporation.

[33] *See, e.g.*, Ernst & Young's 2024 Global Transfer Pricing Survey *available at* http://www.ey.com.

[34] Simon Harst, Deborah Schanz, Felix Siegel, and Caren Sureth-Sloane, *2022 Global MNC Tax Complexity Survey* (2023), available at https://www.accounting-for-transparency.de/wp-content/uploads/2023/11/2022_TCI_Report.pdf.

In the United States, the IRS's Large Business & International Division (LB&I) has undergone significant transformation both in terms of structure and processes geared toward stricter and more comprehensive enforcement of the transfer pricing regulations codified under Section 482 of the Internal Revenue Code.[35]

[35] *See* IRS website, Transfer Pricing Examination Process and IRM, Part 4, 4.61.3 Development of IRC 482 Cases for current audit and examination guidelines (www.irs.gov).

In addition, the IRS has also seen more success in litigating transfer pricing positions than they have historically, such as in the 2019 Tax Court decision in *Altera Corporation*, 926 F.3d 1061 (9th Cir. 2019); the November 18, 2020, Tax Court decision in *Coca-Cola Company*, 155 T.C. 145 (2020); and the 2023 Tax Court decision in *3M Company*, 160 T.C. No. 3 (2023).[36] We discuss significant transfer pricing litigation, environment, and outcomes in more detail in Section VI and Section VII of this Portfolio.

[36] Steven C. Wrappe and Chris Lee, *Increased U.S. transfer-pricing enforcement: What's at stake?* The Tax Adviser (Feb. 1, 2024) (https://www.thetaxadviser.com/issues/2024/feb/increased-us-transfer-pricing-enforcement-whats-at-stake.html).

Comment: The changes in increased U.S. regulatory enforcement and scrutiny by the IRS with respect to transfer pricing are mirrored by tax authorities globally. Tax authorities globally are more aggressive than they had been historically with respect to transfer pricing-related tax positions and the pursuit of penalties if an underpayment of tax is found.

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D. Documenting UTPs

Intercompany transactions between pairs of legal entities should be captured for each transaction and then grouped by jurisdiction. For example, if a U.S. entity is providing management services to multiple related parties in different tax jurisdictions, the annual transaction with each service recipient should be listed separately.

Compiling UTPs into a matrix should allow an entity and its financial auditor to filter or sort the data by various categories. The benefit of this method is that the initial filtering process can highlight those transactions that do not require further analysis (e.g., because the taxable year is closed) and focus attention on those transactions that require further analysis to determine if potential tax exposures exist.

Comment: In capturing the data related to each UTP, there is certain information that the entity's financial auditor will likely need to evaluate in determining if potential tax exposures exist under ASC 740-10. An entity should consider developing a process for listing relevant information for each UTP. Recommended information to be considered should include the taxable year in which the transaction occurred, the type of transaction, the size of the transaction, the tax rate in each jurisdiction, the legal entity name and jurisdiction of the provider and receiver and whether the taxable year of the transaction is open or closed. For a detailed illustration, see the reference example matrix provided in Exhibit 2 within Worksheet 2.

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E. Unique Aspects of Transfer Pricing Exposures

Unfortunately, despite the relative importance of transfer pricing in the determination of uncertain tax positions, there is very little direct mention of transfer pricing in ASC 740-10, and guidance on how to treat transfer pricing-related tax positions is omitted from the standard.

The only guidance related to transfer pricing in ASC 740-10 is contained in an example in ASC 740-10-55-217. The example assumes that a company has already implemented ASC 740-10's Recognition and Measurement steps and demonstrates how it should disclose its uncertainty in income taxes. Although this example is somewhat informative about the level of detail required for disclosure (which is discussed in further detail in VII., below), the example provides little guidance on how to actually analyze transfer pricing positions under ASC 740-10.

Comment: Worksheet 1 presents a recommended process for applying ASC 740-10 to transfer pricing. It outlines a set of steps that identify, assess and disclose UTPs. The steps in this process correspond to the following Sections within this Portfolio:

Step 1 — Identifying UTPs and Recognition

- Section III. Units of Account and Identifying Uncertain Tax Position Related to Transfer Pricing.

Step 2 and 3 — Measurement Preliminary Analysis and Scenario Development

- Section IV. Evaluating the Arm's Length Nature of Intercompany Pricing
- Section V. Recognition of Uncertain Tax Positions Related to Transfer Pricing
- Section VI. Measurement Analysis

Step 4 — Implementation

- Section VII. Disclosures

The lack of formal regulatory guidance with respect to transfer pricing-related tax positions gives rise to many questions at each stage of the process for evaluating uncertain tax positions under ASC 740-10. A sample of these questions is presented below.

- How should a Unit of Account be defined for transfer pricing-related tax positions?

Each Unit of Account represents a tax position that must be analyzed under ASC 740-10. A wide variety of possible solutions exist for defining Units of Account for transfer pricing-related tax positions. For example, an MNE might describe a Unit of Account as “U.S. outbound sales of products.” This is very broad and would likely lead to a low number of Units of Account to analyze. Alternatively, it could define its Units of Account at a more granular level by distinguishing a separate Unit of Account for each transaction, as defined by annual amounts transferred between each pair(s) of jurisdictions, for a particular transaction type. An example of a Unit of Account under this approach would be something like “U.S. sales of raw materials to France in 2024.” Such an approach would likely lead to numerous Units of Account to analyze under the Recognition and Measurement Steps of ASC 740-10. Section III.A. of this Portfolio provides more detail on how to define a Unit of Account for UTPs related to transfer pricing.

- How should the Recognition step be interpreted for transfer pricing positions?

A company must analyze each Unit of Account under the Recognition rules in ASC 740-10 to determine whether it may recognize the tax position(s) in its financial statements. The basic rule is that the tax effects of a tax position may be recognized in financial statements if it is more likely than not that the position will be sustained upon examination by the tax authority. However, there is no specific rule governing how the Recognition step should be interpreted for transfer pricing positions.

Comment: Two interpretations could potentially be relevant to Recognition of a transfer pricing position. First, one could interpret the MLTN standard such that the actual price(s) charged must be greater than 50 percent likely of being sustained under audit in order for any tax benefits generated by the associated Unit of Account to be recognized. Another interpretation considers the MLTN standard applicable to the allocation of any income or expense pursuant to the intercompany transaction(s) in question, addressing the appropriateness of the actual price(s) charged under the Measurement step. Section VI of this Portfolio contains a more detailed discussion of these interpretations.

- What should companies consider under the Measurement step of ASC 740-10?

ASC 740-10 requires that Units of Account that meet the MLTN threshold must be measured at the largest amount of tax benefit that is greater than 50 percent likely of being realized upon effective settlement with a tax authority that has full knowledge of all relevant information. Measurement must consider the amounts and probabilities of the outcomes that could be realized upon effective settlement. In transfer pricing, the number of outcomes for any given transaction could be infinite.[37] Given this, how should MNEs interpret the requirements of the Measurement step for intercompany transactions? Section VI of this Portfolio presents a discussion of best practices regarding effective processes for Measurement in transfer pricing.

[37] The possibility of disputes over multiple comparables, over the method selected, the use and interpretation of data within an analysis and the overall characterization of the transaction further multiplies the number of potential outcomes that might need to be evaluated under ASC 740-10.

• Transfer pricing involves multiple tax authorities. How should these be taken into account in ASC 740-10 analyses?

MNEs have several mechanisms for resolving transfer pricing disputes, and these options make it difficult to interpret the "effective settlement" definition of ASC 740-10.[38] Specifically, how does one consider these alternatives for resolving transfer pricing disputes when quantifying an outcome under the Measurement step of ASC 740-10? When is it appropriate to assume that an MNE will successfully dispute a proposed transfer pricing adjustment during an audit cycle? When is it appropriate to assume that it would seek MAP relief to relieve double taxation? How can one estimate the resulting transfer price upon effective settlement with a tax authority without knowing what perspective the relevant tax authorities will take with respect to a given transaction? While there is no formal guidance provided on these issues under ASC 740-10, Section VI of this Portfolio contains a more detailed discussion of these issues.

[38] Under ASC 740-10-25-8(b), an entity must recognize the benefit of a tax position when it is "effectively settled." Therefore, a proper understanding of effective settlement is important when applying ASC 740-10 to uncertain tax positions related to transfer pricing. *See* Section VI.D.2.e. of this Portfolio for a discussion of effective settlements.

The following Sections of this Portfolio address these and other important questions that arise when performing ASC 740-10 analyses of transfer pricing-related tax positions.

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Section III explains why uncertainties related to transfer pricing matters should be evaluated at the level of annual amounts charged for given transaction types between pairs of legal entities. The definition of a Unit of Account provided within ASC 740-10 is discussed along with its application to transfer pricing.

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A. Defining a Unit of Account Under ASC 740-10

In defining a Unit of Account, ASC 740-10 requires an entity to consider how it typically supports the tax position reported on its tax return and how the tax authorities typically evaluate the position under a tax audit. ASC 740-10-25-13 allows for the entity's judgment in establishing an appropriate Unit of Account based upon the facts and circumstances of the tax position under evaluation. The definition as presented within ASC 740-10-25-13 is provided below.

> The appropriate unit of account for determining what constitutes an individual tax position, and whether the more-likely-than-not recognition threshold is met for a tax position, is a matter of judgment based on the individual facts and circumstances of that position evaluated in light of all available evidence. The determination of the unit of account to be used shall consider the manner in which the entity prepares and supports its income tax return and the approach the entity anticipates the tax authority will take during an examination. Because the individual facts and circumstances of a tax position and of an entity taking that position will determine the appropriate unit of account, a single defined unit of account would not be applicable to all situations.[39]

[39] ASC 740-10-25-13.

The definition of Unit of Account allows the taxpayer some flexibility in using judgment based upon how the tax position under analysis has historically been presented within its tax return, and subsequently, audited by the tax authorities.

In determining appropriate Units of Account, the taxpayer must consider how issues are reported or categorized on its income tax return and how the tax authorities typically approach such issues as part of an audit. This guidance for establishing Units of Account serves as the basis for grouping intercompany transactions when applying ASC 740-10 to transfer pricing, as discussed in B., below.

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B. Defining a Unit of Account Related to Transfer Pricing

In defining a Unit of Account related to transfer pricing, one first refers to the definition provided under ASC 740-10. As described in III.A., ASC 740-10 requires taxpayers to define a Unit of Account based upon how they prepare and support their tax return and how tax authorities are expected to evaluate them under a tax audit. The tax positions taken by an MNE with respect to its transfer pricing are the result of intercompany transactions between two or more entities. Although the value of the intercompany transaction affects the reported income in the relevant tax jurisdictions, it is not the resulting tax that is directly evaluated but whether the value of the intercompany transaction is appropriate.

For the development of a Unit of Account within transfer pricing, the following factors (among others) should also be considered:

1. Level of Aggregation/Disaggregation of the Intercompany Transactions — The taxpayer will need to determine, based on the facts and circumstances of the covered transactions, the appropriate level of disaggregation/aggregation of the intercompany results

2. Categorization/Type of Intercompany Transaction(s) — The taxpayer must differentiate the types of intercompany

transaction being reported (e.g., transfers of tangible property, services, intangibles, financing, etc.) as each type of transaction gives rise to unique characteristics and guidance.

3. Significance and Materiality of the Tax Position — The taxpayer must assess the significance and materiality of the tax position and whether it requires additional analysis.

4. Presentation of Information regarding the Intercompany Transaction(s) — The taxpayer must be prepared to provide documentation and support to the relevant tax authorities for its positions. How is the information pertaining to the intercompany transaction(s) going to be collected, summarized, and presented?

5. Level of Support for the Intercompany Transaction(s) — What analysis(es) and level of support (e.g., documentation, intercompany agreements, APAs, etc.) does the taxpayer have to defend its transfer pricing position?

Upon selecting a Unit of Account, it is important to remain consistent in future analyses. Therefore, once a Unit of Account for a given tax position has been determined, it should be applied consistently to that position from period to period, unless a change in the facts and circumstances suggest that a change in the analysis is warranted.

The following subsections further detail considerations for determining Units of Account for UTPs related to transfer pricing.

1. Level at Which Multinational Enterprises Prepare and Support Transfer Pricing Positions on Income Tax Returns —

Determining the Unit of Account for transfer pricing positions is based upon how intercompany transactions are treated within the underlying transfer pricing regulations. The manner in which intercompany transactions are addressed within the regulations is then followed by taxpayers in the development of their transfer pricing policies and supporting documentation before an audit, as well as tax auditors in conducting transfer pricing audits.

MNEs prepare transfer pricing documentation to support their intercompany pricing according to the local transfer pricing documentation requirements for the countries in which they have intercompany transactions.

The U.S. transfer pricing documentation regulations are found in Treasury Regulations *§1.6662*. These regulations establish penalties for not having prepared transfer pricing documentation contemporaneously with the filing of the corresponding year's tax return, and providing that documentation within 30 days of an IRS request.[40]

[40] See *The Section 6662(e) Substantial and Gross Valuation Misstatement Penalty* tutorial provided by the IRS for additional details regarding U.S. transfer pricing documentation and penalty protection guidance. https://www.irs.gov/pub/irs-apa/penalties6662_e.pdf; *see also* 6924 T.M., *Transfer Pricing: Audits, Appeals, and Penalties*.

Reg. §1.6662-6(d)(2)(iii)(B) sets forth the 10 principal documents that must be maintained by a taxpayer to satisfy the transfer pricing requirement in the United States. The 10 principal documents are typically organized in the form of a U.S. transfer pricing report. The presentation of this documentation is important for determining how to define a Unit of Account for transfer pricing purposes, since transfer pricing reports will serve as the means by which taxpayers prepare and support the impact of transfer pricing on income tax returns. Transfer pricing reports will routinely list out the material annual intercompany transactions that an entity has entered into for the year under analysis. In the reports, transactions are typically categorized separately into tangible goods, intangibles, financing, and services, which correspond to different regulatory sections and specified methodologies within the U.S. transfer pricing regulations.

The OECD Transfer Pricing Guidelines specify documentation requirements in a three-tiered system depending on the size of the MNE: a master file containing information regarding the MNE's global operations, industry, and other globally relevant items, a local file containing documentation specific to the operations of the entity or entities in one tax jurisdiction, and a country-by-country report that presents data on the global allocation of income, profit, taxes paid, and economic activity among tax jurisdictions in which an MNE operates. Most countries outside the United States have transfer pricing documentation requirements consistent with the OECD structure, although some have requirements that go beyond those of the OECD Transfer Pricing Guidelines. The 10 principal documents of Reg. §1.6662-6 and the OECD documentation requirements overlap in many ways, but some differences exist and must be taken into consideration when preparing global transfer pricing documentation.

2. Defining a Unit of Account at the Income/Expense Level vs. Tax Benefit —

Because adherence to the arm's length standard requires comparing *prices or profit level indicators* of a controlled entity to those observed in comparable uncontrolled situations, transfer prices are supported at an income or expense level rather than at the level of tax benefit. Therefore, as arm's length ranges are generally derived from prices or profit level indicators (profit margins), it is reasonable to define a Unit of Account for transfer pricing at this same level. Using income or expense as the starting point in defining a Unit of Account under ASC 740-10 is commonly applied by transfer pricing practitioners.

3. Use of Annual Amounts —

Intercompany transactions are typically listed in cumulative amounts incurred during a taxpayer's taxable year. For example, Forms 5471 and 5472, which are filed in conjunction with a taxpayer's U.S. tax return, require the reporting of annual amounts of specified inbound and outbound intercompany transactions with the U.S. taxpayer. Similarly, transfer pricing documentation requirements in the United States and in most countries worldwide expect the analysis to be conducted on the annual amounts of each type of intercompany transaction.[41]

[41] Certain countries may require more detail with respect to how transaction data is provided. Local documentation rules should be considered in determining whether and how to aggregate intercompany transactions.

4. Pairs of Jurisdictions —

Each tax authority has its own interpretation or technical guidance on how transfer prices should be evaluated. The existence of tax treaties or other relationships among tax jurisdictions will affect the outcome of a disagreement over transfer prices and the effective settlement of transfer pricing disputes.

The subsections above present examples of how taxpayers typically report intercompany transactions on their income tax returns. These examples should be considered in developing Units of Account for transfer pricing. In addition, the approach that a tax authority would take to audit the intercompany pricing of these transactions should also be considered. The following Section discusses how to identify and document Units of Account thus defined.

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C. Applying Initial Filters

Due to the number of UTPs that may be considered in a company's analysis, the initial focus tends to be on whether the process as a whole is reasonable, with significant UTPs then being identified for additional individual scrutiny. When evaluating UTPs, management will want to confirm that, with significant UTPs then being identified for additional individual scrutiny. When evaluating UTPs, management will want to confirm that:

- Scenarios are identified objectively (i.e., reflect what would realistically be expected);
- Scenarios consider both sides of a transaction. Given that in most cases there will be two tax authorities involved, each with its own interpretation or technical guidance on how transfer prices should be set, both sides of the transaction need to be taken into account simultaneously when determining all outcomes; and
- Scenarios appropriately represent "effective settlement" as defined in ASC 740-10-25-10.

Once an MNE has identified its full universe of transfer pricing-related Units of Account to be evaluated, it will be helpful to identify Units of Account that will not have any material impact on the company's ASC 740-10 reserve and can therefore be ignored in the analysis. In this Portfolio, this concept is referred to as applying "Initial Filters."[42]

[42] Initial filters are not discussed within ASC 740-10; rather, they represent a best practice for companies that have numerous UTPs related to transfer pricing.

Worksheet 2 illustrates the use of filters including the removal of UTPs due to immateriality, the intra-jurisdiction nature of the transaction, closed taxable years, lack of regulatory requirements or other factors. This process may eliminate the need to analyze certain UTPs identified because they represent transactions that would not have a material impact on the ASC 740-10 reserve calculation.

1. Immateriality —

Although materiality is probably the most common filter applied to transfer pricing UTPs, one complication in applying a materiality filter is that there are no specific materiality guidelines related to ASC 740-10. In other words, a strict interpretation of ASC 740-10 would require that all UTPs be addressed, no matter how small. For many large multinationals, this would be an impossible exercise given the hundreds or even thousands of intercompany transactions that a multinational enterprise may have in any given year.

However, despite the lack of guidance in ASC 740-10 itself, many MNEs have found success in agreeing with their auditors that materiality standards need to be applied to ASC 740-10 analyses. For MNEs with large numbers of intercompany transactions, it may be difficult to verify every journal entry, transaction, and other financial activity that is ultimately incorporated into its financial statements. It is not uncommon for auditors to issue an opinion on financial statements with a reasonable level of assurance. The auditors' responsibilities are in fact limited with respect to materiality according to generally accepted auditing standards (GAAS). According to GAAS, an auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. However, the auditor does not have a responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.[43]

[43] PCAOB *AU 110.02* (applicable to issuers); https://pcaobus.org/oversight/standards/archived-standards/pre-reorganized-auditing-standards-interpretations/details/AU110. AICPA AU-C 200.06 –AU-C 200.07 (applicable to non-issuers); https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-c-00200.pdf.

As materiality relates to the very foundation of an auditor's responsibilities, there is a compelling reason for an MNE to have dialogue about potential immaterial items that would not need to be included in an ASC 740-10 analysis.

Therefore, it is not uncommon for MNEs and their auditors to agree on certain materiality thresholds to be applied at the outset of their ASC 740-10 analysis process. The way these materiality thresholds are defined will vary. Examples of such thresholds that have been applied for intercompany transactions may include:

- Annual actual dollar amounts of transaction (i.e., all UTPs that represent transactions less than $X for a given taxable year can be excluded from the analysis), and

- Cumulative actual dollar amounts of recurring transaction (i.e., for any UTP that represents a recurring transaction, such Units of Account can be eliminated from the analysis if the cumulative sum of such transaction for all open years is less than $X).

Comment: When determining whether a transfer pricing transaction is material it is important to consider whether the existing transfer pricing methodology and price would be considered arm's length and assess what the impact on materiality would be if it was not. If the actual arm's length amount is significantly different than the recorded amount, the previously immaterial position may become material when corrected to reflect an arm's length price. For example, consider a transaction in which no royalty has been charged and the company has determined that the transaction is immaterial for ASC 740-10 purposes. However, upon review, it is found that a royalty should have been in place. The difference between 0 percent royalty and an arm's length return (e.g., 10 percent royalty on net sales) may push an immaterial amount to become a material position.

2. Relative Risk —

The nature of the transaction, and relative risk inherent in such transaction, represented by a UTP may also impact whether that UTP may be removed from the ASC 740-10 analysis. Therefore, auditors may choose to characterize transactions as “high-risk,” “low-risk,” or “no-risk” depending on the nature of the transaction and proceed accordingly.

3. Intra-Jurisdiction Transactions —

To the extent that an adjustment in transfer price for intra-jurisdictional transactions (for example intercompany transactions between related-party entities located in different states or provinces) does not affect the income tax due within that jurisdiction, the financial auditors may agree that these transactions do not require further analysis.

4. Closed Tax Years —

ASC 740-10-25-8 outlines certain conditions under which UTPs do not require further analysis. This includes tax positions where the MLTN recognition threshold is met by the reporting date; that are “effectively settled” through examination, negotiation, or litigation; and those for which the statute of limitations for the relevant tax authority to examine and challenge the positions has expired.

When evaluating tax positions under ASC 740-10 taxpayers should identify those UTPs for years in which the statute of limitations remains open and that have not been “effectively settled” through prior examination, negotiation, or litigation, typically referred to as “open taxable years.”

Because transfer pricing involves multiple jurisdictions, tax positions for open taxable years need to be considered separately for each jurisdiction. For example, a UTP involving the United States and Germany may occur in an open taxable year for U.S. purposes, however, the statute of limitations may have expired for that same UTP in Germany. When identifying UTPs, taxpayers should develop a list of open taxable years for each relevant jurisdiction. If a taxpayer has recently concluded an audit in a tax jurisdiction or the statute of limitations for auditing transactions within a jurisdiction has expired, the intercompany transactions for the closed taxable years within that jurisdiction may not require further evaluation for purposes of applying ASC 740-10.

5. Lack of Regulatory Requirements —

Finally, initial filters may highlight certain tax jurisdictions that do not currently have established transfer pricing regulations and penalties and, as such, the risk of an adjustment resulting from transfer pricing in that jurisdiction is eliminated. However, this is becoming increasingly rare as currently there are very few countries that do not have transfer pricing regulations.

6. Conclusion Regarding Use of Filters —

It is ultimately at the auditors' discretion to determine what could be excluded from the analysis through the application of initial filters. Having an item excluded from the analysis necessarily assumes that it has no material effect on the ASC 740-10 reserve to be reported, so auditors must be careful in agreeing to any such screens or filters. Communication at the outset of the ASC 740-10 analysis between the MNE, its auditors, and its transfer pricing advisor is critical to determining the appropriate transfer pricing Units of Account to be considered for analysis.

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IV. Evaluating the Arm's Length Nature of Intercompany Pricing

This Section summarizes the process of evaluating the arm's length nature of intercompany charges, which is the core of ASC 740-10 analyses related to transfer pricing positions. This Section provides a foundation for understanding how to evaluate transfer pricing positions within ASC 740-10's Measurement step, which is discussed in Section VI of this Portfolio.

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A. Relationship to ASC 740-10 Analysis

ASC 740-10 requires an entity to evaluate whether the benefits of a given tax position may be recognized in a company's financial statements, and to measure the greatest amount of benefit that has a cumulative probability of greater than 50 percent of being sustained. In the context of transfer pricing, the question of whether the transfer price is sustainable under examination by a tax authority is answered by whether it would meet the arm's length standard of the relevant tax authorities. As a result, the evaluation of the arm's length nature of intercompany prices is a crucial step in ASC 740-10 analysis of transfer pricing positions.

In the United States, transfer pricing is governed by Section 482 of the Internal Revenue Code under which the IRS "may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount."[44] The U.S. definition of the arm's length standard is set forth in Reg. §1.482-1(b)(1) and states that "[i]n determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."

[44] Reg. §1.482-1(a)(2).

Comment: Although transfer pricing "shorthand" often refers to transfer pricing adjustments as "income adjustments," when evaluating positions for ASC 740-10, it is important to include the evaluation of deductions as well as any other items that may affect income.

Although taxpayers have the responsibility of setting their intercompany pricing, most tax jurisdictions have established tax legislation providing their tax authorities with the right to review and adjust the taxpayers' pricing if they determine that it is not arm's length. For example, Section 1.482-1(a)(2) of the U.S. Treasury Regulations grants the IRS the right to make adjustments while paragraph 1.3 of the 2022 OECD Transfer Pricing Guidelines states that OECD Member countries have agreed that "for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby that the arm's length principle is satisfied."[45]

[45] The OECD Transfer Pricing Guidelines may or may not have the force of law depending on whether an OECD Member country incorporates these into its existing tax law.

Transfer pricing exposure then is the risk that, under audit, a tax authority will disagree with a taxpayer's transfer pricing. To measure the likelihood that any proposed adjustment will ultimately be sustained and affect a company's tax position, one compares the original position taken by the entity to the likely alternative positions the tax authorities might take upon audit.

Section V of this Portfolio discusses how transfer pricing exposure ties to the Recognition step of ASC 740-10, and Section VI discusses the Measurement process. Most relevantly, the Measurement step within ASC 740-10 requires a comparison between what was recorded on a tax return and what would be realized upon effective settlement assuming the Unit of Account is audited by all relevant tax jurisdictions.

Accounting Policy & Practice Portfolios: Accounting for Income Taxes
Portfolio 5004-2nd: Accounting for Income Taxes: Uncertain Tax Positions in Transfer Pricing
Detailed Analysis
IV. Evaluating the Arm's Length Nature of Intercompany Pricing

B. Key Considerations When Evaluating Transfer Pricing Exposures

This Section describes the nature of transfer pricing exposures and the key considerations for evaluating and quantifying such exposures. It first provides context for how transfer pricing adjustments affect financial statements and taxable income. It then explains how exposures are generally driven by disagreements over what the arm's length price for a given intercompany transaction should be.

Transfer pricing disagreements generally arise from different interpretations and applications of the relevant transfer pricing guidance by tax authorities and taxpayers. This guidance relates both to the selection of the appropriate methodology to evaluate an intercompany transaction, and to the application of that methodology. These disagreements are often exacerbated by the nature of transfer pricing itself. Specifically, transfer pricing law and regulation is not formulaic but provides general principles, the application of which is driven by the specific facts underlying intercompany transactions. But by understanding the regulatory underpinnings of transfer pricing in specific situations and the areas in which discrepancies are likely to occur, entities can more effectively evaluate when transfer pricing exposures exist. This knowledge serves as a foundation for analyzing such exposures under the Recognition and Measurement steps of ASC 740-10.

As outlined in the IRS's Transfer Pricing Documentation Best Practices Frequently Asked Questions (FAQs),[46] the answer to question 1 relating to the benefits of taxpayers preparing robust transfer pricing documentation explains that:

[46] IRS.gov, *Transfer pricing documentation best practices frequently asked questions (FAQs),* https://www.irs.gov/businesses/international-businesses/transfer-pricing-documentation-best-practices-frequently-asked-questions-faqs, accessed on Aug. 30, 2024.

> Transfer pricing reports that comprehensively document the reasonable selection and application of a transfer pricing method, consistent with the requirements of §6662(e), help demonstrate low levels of compliance risk and in turn help support early deselection of the transfer pricing issue from further examination. High-quality transfer pricing documentation allows the examining agent to rely on the taxpayer's analysis of functions, risks, intangibles, value drivers, etc., saving both the taxpayer and the IRS time examining low-risk transfer pricing issues.

1. Transfer Pricing Adjustments Defined —

The transfer pricing positions taken by a multinational group directly affect the amount of taxable income that is earned in each jurisdiction that is party to the intercompany transactions. When the tax authority from one jurisdiction conducts an audit of an entity's transfer pricing positions, it is most often focused on determining whether those positions are arm's length. Upon auditing a company's transfer pricing positions, if the tax authority concludes that transfer prices are not arm's length, it may propose an adjustment to those transfer prices. Although the audit process can vary across tax jurisdictions, a proposed adjustment to an entity's transfer pricing can be described as a transfer pricing position taken by a tax authority that differs from the transfer pricing position taken by the taxpayer. This difference generally results in an increase in taxable income (or a decrease in an operating loss) in the jurisdiction where the audit took place.

2. Transfer Pricing Audit Process —

In evaluating the likely outcome of a transfer pricing adjustment, it is important to understand the audit process that may result in an adjustment. Depending on the jurisdiction, the process may vary in terms of the number of past tax years that are open for audit, the information-gathering process during the audit, the time allowed for the taxpayer to respond, and the type and amount of penalties that may accompany a transfer pricing adjustment. This Portfolio's discussion is limited to the audit process followed by the IRS in the United States.

Although transfer pricing has been a high-profile issue for the IRS for many years, the IRS historically has had neither the funding nor the personnel to pursue a significant number of transfer pricing audits. With the passage of the Inflation Reduction Act in August 2022, however, the IRS received significant additional funding to increase personnel, training, and other resources. As part of this funding, the IRS stated its intention to, among other initiatives, increase its review of intercompany transactions. In its April 2023 Strategic Operating Plan,[47] the IRS stated in part that:

[47] Internal Revenue Service Inflation Reduction Act Strategic Operating Plan FY2023 – 2031, Apr. 5, 2023 (https://www.irs.gov/pub/irs-pdf/p3744.pdf).

> Large corporations have complicated, voluminous tax filings that involve a variety of tax issues such as crossborder [sic] activities, financial product issues and transfer-pricing transactions. Ensuring that large corporations pay the taxes they owe is a complex endeavor and requires significant resources and a range of specialists. We will increase audit rates and other compliance treatments, focusing on the largest corporate taxpayers where audit rates have been too low. We will use data and analytics to improve our understanding of these complex tax filings. We will pursue noncompliance through a variety of mechanisms, including audits and non-audit contacts.

On October 20, 2023, the IRS announced new initiatives focused on ensuring large corporations are paying taxes owned.[48] Among these initiatives, the IRS highlighted its increasing compliance efforts involving situations where a U.S.

subsidiary of foreign companies distributes goods into the United States. Specifically, taxpayers reporting a U.S. distributor earning "losses or exceedingly low margins year after year through the improper use of transfer pricing to avoid reporting an appropriate amount of U.S. profits"[49] should expect increased scrutiny and examination. As part of this initiative, the IRS issued compliance alert letters to approximately 180 U.S. subsidiaries of large foreign corporations to "reiterate their U.S. tax obligations and incentivize self-correction."[50] Letter 6607 instructs taxpayers to provide confirmation that their transfer pricing complies with U.S. IRC §482 and notes that failure to do so may result in an audit.[51]

[48] *See* IRS News Releases IR-2023-194 (Oct. 20, 2023) (https://www.irs.gov/newsroom/irs-launches-new-initiatives-using-inflation-reduction-act-funding-to-ensure-large-corporations-pay-taxes-owed-continues-to-improve-service-and-modernize-technology-with-launch-of-business-tax-account); and IR 2024-09 (Jan. 12, 2024) (https://www.irs.gov/newsroom/irs-ramps-up-new-initiatives-using-inflation-reduction-act-funding-to-ensure-complex-partnerships-large-corporations-pay-taxes-owed-continues-to-close-millionaire-tax-debt-cases).

[49] IR-2023-194 (https://www.irs.gov/newsroom/irs-launches-new-initiatives-using-inflation-reduction-act-funding-to-ensure-large-corporations-pay-taxes-owed-continues-to-improve-service-and-modernize-technology-with-launch-of-business-tax-account).

[50] IR-2023-194 (https://www.irs.gov/newsroom/irs-launches-new-initiatives-using-inflation-reduction-act-funding-to-ensure-large-corporations-pay-taxes-owed-continues-to-improve-service-and-modernize-technology-with-launch-of-business-tax-account). The IRS updated this number from 150 to 180 in January 2024, in IR 2024-09 (Jan. 12, 2024) (https://www.irs.gov/newsroom/irs-ramps-up-new-initiatives-using-inflation-reduction-act-funding-to-ensure-complex-partnerships-large-corporations-pay-taxes-owed-continues-to-close-millionaire-tax-debt-cases).

[51] Letter 6608 was issued to taxpayers reporting losses or low margins on U.S. distributors but differs from Letter 6607 in that a response is required only if the taxpayer believes that its transfer pricing was not in line with I.R.C. §482.

As noted above, the IRS has also issued FAQs on transfer pricing documentation best practices.[52] It also released a generic legal advice memorandum (GLAM) on intercompany loans in late 2023.[53] All of these IRS initiatives were part of an IRS effort to boost transfer pricing compliance outside of the formal audit process.

[52] IRS.gov, *Transfer pricing documentation best practices frequently asked questions (FAQs),* https://www.irs.gov/businesses/international-businesses/transfer-pricing-documentation-best-practices-frequently-asked-questions-faqs, accessed on Aug. 30, 2024.

[53] Office of Chief Counsel, IRS Memorandum, AM 2023-08, Dec. 29, 2023, https://www.irs.gov/pub/lanoa/am-2023-008.pdf.

When the IRS does initiate a transfer pricing audit, it may be conducted as part of a broader IRS examination of a taxpayer, or it may be limited in scope to focus on transfer pricing issues. IRS Publication 5300, "Transfer Pricing Examination Process" (TPEP) provides guidance to the IRS exam team and taxpayers regarding how a transfer pricing examination will be conducted.[54] Under the TPEP approach, a U.S. transfer pricing audit consists of three distinct phases:

[54] Department of the Treasury — Internal Revenue Service, "Transfer Pricing Examination Process" Publication 5300 (Rev 9-2020) Catalog Number 71492Y.

(1) Planning Phase, which includes a review of prior year workpapers, analysis of tax returns including, if applicable, the country-by-country report, preparation of ratio analysis, and research into the taxpayer's operations. From this, the exam team develops an initial transfer pricing risk assessment and preliminary working hypothesis. The Planning Phase concludes with an Opening Conference with the taxpayer, at which time the scope of the audit

will be discussed.

(2) Execution Phase, which includes fact finding, information gathering, and the drafting of IRS positions and reports. During the Execution Phase, the exam team will continue to develop its understanding of the facts related to the taxpayer. This will include performing a functional analysis, which may include interviews with taxpayer personnel and site tours. Publication 5300 notes, “A functional analysis is a critical aspect of any transfer pricing examination and is best conducted as a team with robust internal communication, and ongoing discussions with the taxpayer to further understand its business operations.”[55]

[55] TPEP, p. 24.

An IRS economist is an integral member of the exam team, and during the Execution Phase, the economist prepares a draft Economist Report, which consists of the factual background and functional analysis of the taxpayer and transaction at issue, a summary of the taxpayer's economic analysis, the economist's critique of the taxpayer's methodology, and the IRS economist's determination of the arm's length price. Following this, the exam team prepares a draft Notice of Proposed Adjustment (NOPA). The NOPA summarizes the IRS position, including the issue, the facts, the governing law, the taxpayer's position, and the IRS position. The TPEP notes that the facts related to the transaction at issue should be agreed upon with the taxpayer “whenever possible.”[56]

[56] TPEP, p. 29.

Penalties are also considered during the Execution Phase. The TPEP states that:

> Regulations require the IRS to apply penalties when the taxpayer fails to create or to timely provide IRC §6662(e) documentation or when the IRC §6662(e) documentation provided is unreasonable or inadequate, assuming the net adjustment penalty thresholds are met. IRC §6662(e) documentation does not automatically protect against penalties because the IRC §6662(e) documentation must be assessed for adequacy and reasonableness. To meet the reasonable cause exception of the penalty regulations, taxpayers must document they reasonably selected the best method for their analysis and they reasonably applied that best method. Factors to consider in evaluating the adequacy of a taxpayer's transfer pricing documentation are outlined in the regulations.[57]

[57] TPEP, p. 28.

Depending on the size of the transfer pricing adjustment, penalties may be 20% or 40% of the additional tax due.

Since transfer pricing is a uniquely fact-based tax issue, before issuing a final Economist Report and NOPA, the TPEP specifies that the exam team should issue an “Acknowledgement of Facts” IDR to ensure that it reaches correct conclusions based on agreed facts.

(3) Resolution Phase, during which the examination is concluded, either because agreement between the IRS and the taxpayer is reached, or because there is no agreement and the issue moves to dispute resolution. If the taxpayer and exam team agree on an adjustment, reports are finalized and final adjustments, including tax, interest, and penalties, are calculated.

If the taxpayer and exam team do not reach an agreement, then the exam team issues a final NOPA and Economist Report. A Revenue Agent's Report (RAR) and 30-day letter are also issued, which provides the taxpayer the right to dispute the RAR through a Taxpayer Protest. At this point, there are several routes that the taxpayer may follow to try to resolve the audit.[58] Depending on the resolution process chosen and the complexity of the issue, resolution of a transfer pricing dispute can take five years or more.

[58] The transfer pricing audit process is discussed in more detail in 6924 T.M., *Transfer Pricing: Audits, Appeals, and Penalties*.

3. Effect of Transfer Pricing Adjustments on Financial Statements —

The transfer pricing positions taken by an enterprise are reflected in its statutory (either consolidated or unconsolidated) financial statements as well as in its jurisdictional tax returns. For example, if a company is selling product to an affiliated entity, the transactions will be recorded as intercompany sales on the selling entity's income statement. Such transactions also will create an intercompany accounts receivable on its balance sheet. The amount recognized as intercompany sales directly affects that amount of taxable income recorded on the local country or statutory financial statements.

In the United States, financial statements are required to be prepared according to U.S. GAAP while taxable income is computed to comply with the U.S. Tax Code. Differences that arise between income reported within a U.S. company's financial statements (often referred to as "book income") and income reported in its tax return (often referred to as "tax income"), are reconciled in Schedule M of tax Form 5471, which is included as part of the company's U.S. tax return filing.

Differences in pre-tax book income and taxable income are segmented into permanent and temporary differences. Permanent differences are revenue and expense items recognized in arriving at book income in a period that are never reflected in taxable income, such as interest income on municipal bonds. Permanent differences cause the effective tax rate (calculated as current and deferred tax expense divided by pre-tax book income) to be different from the statutory tax rate, which is the tax rate set by the local jurisdiction.

Temporary differences are revenue and expense items that are recognized in arriving at both book income and taxable income, but in different periods. Future deductible tax items resulting from timing differences create deferred tax assets while future tax payables resulting from timing differences create deferred tax liabilities. The company's financial statements reflect total income tax expense on its income statement and net deferred tax asset or liabilities on its balance sheet. The tax effect attributable to temporary differences is computed by applying the statutory tax rate in effect for the period of time considered.

ASC 740-10, when applied to transfer pricing, is focused on identifying potential deferred tax liabilities (i.e., potential future taxes payable resulting from a sustained transfer pricing adjustment). Because there are two parties to every intercompany transaction, each tax jurisdiction that is affected needs to be considered.

4. Mutual Agreement Procedures for Resolving Double Tax Matters —

If the United States has an income tax treaty with the country of the counterparty to an IRS income adjustment on an intercompany transaction, the U.S. taxpayer may be able to request a Mutual Agreement Procedure (MAP) under that treaty. The MAP process directs the competent authorities of the two jurisdictions to try to eliminate any double taxation arising from an income tax adjustment imposed by one of the tax authorities in the jurisdictions in which the intercompany transaction occurs. There is no guarantee, however, that complete relief from double taxation will be granted, and even if it is, relief can be granted entirely by one or the other of the tax authorities, or they can each provide partial relief. In any case, MAP can be a very lengthy process, lasting five years or longer to resolve a case.

In response to the lengthiness of the process, the United States has negotiated binding arbitration clauses into several of its tax treaties. These clauses specify that if MAP has not resolved a double tax issue within a specified period of time — usually two years — the matter will proceed to binding arbitration. However, even with binding arbitration, the outcome of a MAP case is not guaranteed. As of this writing, the United States has binding arbitration provisions in its tax treaties with several countries, including Belgium, Canada, France, Germany, Japan, Spain, and Switzerland.

For various reasons, including the length of time required and the uncertain outcome, some taxpayers forego their right to request MAP assistance, and instead absorb the double taxation. MAP is not available with jurisdictions which do not have income tax treaties with the United States.

In the context of ASC 740-10, the possibility that there may not be complete relief from double taxation through MAP should be considered in both the Recognition and Measurement analysis that is discussed in Section V and Section VI of this Portfolio, respectively.

Comment: From a financial reporting perspective, management should timely evaluate and consider whether it will request MAP assistance for the applicable periods. When assessing an entity's willingness to request MAP assistance, financial auditors will often discuss with the entity its readiness to request MAP assistance on a specific transfer pricing issue, and will look at the entity's overall history in utilizing this process to resolve double tax resulting from transfer pricing adjustments. For intercompany transactions that the U.S. taxpayer enters into with countries that do not have tax treaties with the United States, MAP is not an option and adjustments can result in double tax.

The MAP process is discussed in greater detail in 6928 T.M., *Transfer Pricing: Competent Authority Consideration*.

5. Advanced Pricing Agreements’ Effect on Reducing Transfer Pricing Uncertainty —

Most countries that have formalized transfer pricing rules also provide the ability for taxpayers to request an Advanced Pricing Agreement (APA). An APA allows a taxpayer to establish a prospective agreement (usually five years with the potential to renew) with one or more tax authorities on the methodology used to determine the transfer pricing of an intercompany transaction. As it relates to ASC 740-10, successfully completing a bilateral APA (i.e., an APA in which the tax authorities from both sides of the transaction reach agreement) removes the uncertainty of how the relevant tax authorities will assess a taxpayer's transactions that are covered under the APA. If a unilateral APA (i.e., an APA in which the tax authority from only one side of the transaction participates) is completed, this provides certainty on one side of the transaction but not the other. Therefore, the counterparty not covered by a unilateral APA will need to be evaluated under the Recognition and Measurement stages as discussed in Section V and Section VI of this Portfolio.

Comment: There is general acceptance among financial auditors that if a transaction is covered by a bilateral APA for an open taxable year, the uncertainty of how the tax authorities will treat that transaction for the years covered under the APA has been removed. But APAs can be expensive and time consuming — in 2023 the average amount of time it took for a new bilateral APA to be concluded was over four years.[59]

[59] Announcement and Report Concerning Advance Pricing Agreements, Mar. 26, 2024 (APA Annual Report), p. 12.

Recognizing the substantial time and cost of the APA process, in April 2023, the IRS issued interim guidance in the form of a memorandum to its Treaty and Transfer Pricing Operations (TTPO) employees in LB&I. The memorandum sets out a formalized process along with the criteria to be considered and the IRS personnel to be included in determining whether a proposed APA request likely will be most successfully treated in the APA process or whether it is best moved to another TTPO workstream.[60] The purpose of this guidance is stated below:

[60] IRS Memorandum for Treaty and Transfer Pricing Operations Employees, *LB&I-04-0423-006*, *Interim Guidance on Review and Acceptance of Advance Pricing Agreement (APA) Submissions*, Apr. 25, 2023. https://www.irs.gov/pub/foia/ig/lmsb/lbi-04-0423-0006.pdf.

> The review process included in this guidance is not intended to affect the proper analysis of compliance with the

transfer pricing regulations; it is designed to produce the best result and support the best and highest use of transfer pricing resources for taxpayers and tax administrations. This guidance also is not intended to limit or decrease the number of APA requests accepted by APMA. Rather, its goal is to improve the quality and timeliness of APMA's APA program by providing an early mechanism for identifying potential roadblocks to successfully concluding a proposed APA and opportunities for other paths to certainty.[61]

[61] IRS Memorandum for Treaty and Transfer Pricing Operations Employees, *LB&I-04-0423-006*, Interim Guidance on Review and Acceptance of Advance Pricing Agreement (APA) Submissions, Apr. 25, 2023. https://www.irs.gov/pub/foia/ig/lmsb/lbi-04-0423-0006.pdf.

Exhibit 4.60.3-3 of the IRS memorandum provides a list of criteria to evaluate and develop a recommendation regarding suitability of the APA submission. These criteria include, among others:[62]

[62] *See* IRS Memorandum for Treaty and Transfer Pricing Operations Employees, *LB&I-04-0423-006*, *Interim Guidance on Review and Acceptance of Advance Pricing Agreement (APA) Submissions*, Apr. 25, 2023. (https://www.irs.gov/pub/foia/ig/lmsb/lbi-04-0423-0006.pdf) for full list of criteria specified.

• Experience that APMA may have with the type of request or treaty partner to be involved;

• Materiality and complexity of the transfer pricing issues proposed to be covered by the APA;

• Consideration of alternative workstreams (e.g., Intercompany Compliance Assurance Program (ICAP),[63] joint audit, etc.) as a better suited mechanism to address the taxpayer's transfer pricing issues compared to an APA;

[63] As outlined by the OECD: "(ICAP) is a voluntary programme for a multilateral co-operative risk assessment and assurance process. It is designed to be an efficient, effective and co-ordinated approach to provide multinational enterprise groups (MNE groups) willing to engage actively, openly and in a fully transparent manner with increased tax certainty with respect to certain of their activities and transactions. ICAP does not provide an MNE group with legal certainty as may be achieved, for example, through an advance pricing arrangement (APA)." *OECD (2021), International Compliance Assurance Programme — Handbook for tax administrations and MNE groups*, OECD, Paris, www.oecd.org/tax/forum-on-tax-administration/publications-and-products/international-compliance-assuranceprogramme-handbook-for-tax-administrations-and-mne-groups.html.

• Taxpayer's proposed transfer pricing method;

• Taxpayer's examination history in the United States or applicable foreign jurisdiction;

• Whether the IRS has an interest in examining the covered transaction(s) based on TPPO's workload selection process; and

• The extent to which the transfer pricing issues posed by the covered transactions are secondary to the application of other domestic tax law provisions.

As a result, APAs are often used for complex material transactions in which the taxpayer wishes to eliminate the risk of a transfer pricing adjustment. The taxpayer may have other routine transactions that are not covered under an APA, which would need to be considered for further analysis to assess potential ASC 740-10 exposure.

The APA process is discussed in greater detail in 6920 T.M., *Transfer Pricing: Advance Pricing Agreements*.

V. Recognition of Uncertain Tax Positions Related to Transfer Pricing

This Section discusses the application of the Recognition step and MLTN standard to transfer pricing positions. It provides the necessary framework and context for the more detailed analysis presented in Section VI of this Portfolio.

Discussion of the Recognition step begins with ASC 740-10-25-6, excerpted below.

> An entity shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. The term *more likely than not* means a likelihood of more than 50 percent; the terms *examined* and *upon examination* also include resolution of the related appeals or litigation processes, if any. … The more-likely-than not recognition threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold shall consider the facts, circumstances, and information available at the reporting date. The level of evidence that is necessary and appropriate to support an entity's assessment of the technical merits of a tax position is a matter of judgment that depends on all available information.[64]

[64] ASC 740-10-25-6. 5002 T.M., *Accounting for Income Taxes: Uncertain Tax Positions* (Accounting Policy and Practice Series), Section III, provides a comprehensive overview of the MLTN standard as compared to other standards used in financial reporting and tax reporting.

Separately, under U.S. Treasury Regulations, MLTN is used as the standard for purposes of avoiding certain accuracy-related tax penalties with respect to positions reported on tax returns under IRC §6662. Consistent with the financial reporting standard, the tax return MLTN standard is achieved when the likelihood of a particular tax position being upheld is greater than 50 percent.[65]

[65] *See* Reg. §1.6664-4(f)(2)(b).

The MLTN standard must be applied in assessing if a tax position — including a transfer pricing position — can be recognized in financial statements, and the IRS generally uses the same MLTN standard for avoiding accuracy-related tax penalties under IRC §6662. However, transfer pricing documentation that meets a lower, reasonable basis standard under IRC §6662 is recognized as meeting the standard to mitigate the likelihood that an accuracy-related penalty will be imposed.[66] See Section VII of this Portfolio for more information on transfer pricing penalties and the use of transfer pricing documentation for penalty protection.

[66] The IRS does not specify numeric confidence level standards. However, rules of thumb have been developed and typically, “reasonable basis” equates to a greater than or equal to 20 percent likelihood of a position prevailing on its merits. 5002 T.M., *Accounting for Income Taxes: Uncertain Tax Positions* (Accounting Policy and Practice Series), Section III.A.2.f. specifies Reasonable Basis as a position with a 20 percent to 25 percent likelihood of being sustained.

Under the Recognition step, each tax position is subjected to the MLTN standard to determine whether any benefit from that position can be recognized within the financial statements. Recognition is binary — either a position passes the MLTN standard and moves to the Measurement step, or it fails, and no benefit is recognized.

Central to the concept of Recognition is an understanding of what constitutes a tax position. ASC 740-10-25-13 makes it clear that Recognition is intimately tied to both the definition of "tax position" and the identified "Unit of Account." It is the position that is being subjected to Recognition, and how one determines the Unit of Account that constitutes an individual position, will guide how the Recognition step is applied.

Applying the Recognition step to uncertain tax positions involving transfer pricing requires interpretation, as no specific examples are provided within ASC 740-10-25. The Glossary Section of ASC 740-10 is somewhat helpful when determining how to define a tax position related to transfer pricing. It states, in part, that a tax position is "[a] position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. … The term tax position also encompasses, but is not limited to … an allocation or a shift of income between jurisdictions."[67]

[67] ASC 740-10-20.

But while this definition is a helpful starting point, in that it clearly states that an allocation (or shift) of income between jurisdictions, i.e., transfer pricing, is a tax position, there is still some ambiguity in the application of ASC 740-10 to transfer pricing. The uncertainty about Recognition of tax positions related to transfer pricing can be stated as follows: When applying the Recognition step to tax positions involving the allocation of income between jurisdictions (i.e., transfer pricing), should one evaluate: (1) whether it is more-likely-than-not that *an allocation* of income between jurisdictions caused by a particular intercompany transaction would be sustained (i.e., whether the tax authority would agree that some transfer price should be paid); or (2) whether it is more likely than not that *the specific amount of such allocation* as recorded in a company's tax return would be sustained (i.e., whether the tax authority would agree that the specific transfer price paid was the right price)?

The answer has significant implications for transfer pricing. The regulatory frameworks governing appropriate intercompany pricing rely on subjective decisions, ranges of results, and economic reasoning rather than formulaic approaches that make other types of tax positions more binary. In fact, any one intercompany transaction might have an infinite number of potential arm's length prices, which would make it almost impossible for an MNE to assert that the exact price it identified would have a likelihood of greater than 50 percent of being sustained.

Notwithstanding the lack of ASC 740 guidance specific to transfer pricing, it seems clear that the Recognition question is whether it is more likely than not that an allocation of income between jurisdictions should have occurred. The question of "how much" income is a Measurement question. On this point, ASC 740-10-05-6 states in part that, "a tax position is first evaluated for recognition based on its technical merits. Tax positions that meet a recognition criterion are then measured to determine an amount to recognize in the financial statements."[68] ASC 740-10-25-5 further states that the application of ASC 740-10 "requires the application of a more-likely-than-not *recognition* criterion to a tax position before and separate from the *measurement* of a tax position.[69] (Emphasis added.)

[68] ASC 740-10-05-6.

[69] ASC 740-10-25-5.

Typically, a transfer pricing adjustment will arise if the tax authority asserts that the existing price is not arm's length (i.e., a different measurement). However, the IRS may, in rare cases, disregard the transaction completely (and therefore disallow the resulting allocation of income). For example, the economic substance doctrine allows the IRS to disallow a transaction if it concludes that the transaction does not (1) change the taxpayer's economic position (apart from federal income tax effects) in a meaningful way, and (2) have a substantial purpose (apart from the federal income tax effects).[70]

[70] Internal Revenue Code §7701(o)(1).

In the case of transfer pricing, this interpretation means that the Recognition question is generally, but not always, straightforward. This is because in most cases, as long as something of value has been transferred across a border, most jurisdictions recognize that some sort of payment should be made in exchange for that item of value. It is the amount (i.e., the Measurement) that is most controversial.

Comment: Exceptions to this interpretation may warrant consideration. For example, certain countries have disallowed the portion of a service charge that encompassed stock options from a U.S. entity. One may view this as a Recognition question (perhaps no allocation of income/expenses should be made relative to stock option costs). However, one may also view this as a Measurement question (perhaps there is a cumulative probability of greater than 50 percent that under effective settlement the value assigned to the stock option charges would be zero). For the most part, the treatment of service fees generally is a Measurement question rather than a Recognition question, with the exceptions as outlined above.

VI. Measurement Analyses

Section V described the key principles in determining whether a transfer price is arm's length and demonstrated how challenges to the arm's length nature of a company's transfer price may lead to a transfer pricing adjustments. Evaluating the arm's length nature of a particular transfer pricing position is not a separate step; it in fact forms a crucial part of the Measurement step within ASC 740-10. This Section provides a detailed process for how to measure UTPs given a company's exposure to such adjustments under the framework of ASC 740-10. Particularly, it addresses the specific requirements of ASC 740-10 for this step and why it can be difficult to apply these requirements to transfer pricing positions. The following sections contain summaries of best practices for conducting an ASC 740-10 analysis specifically related to transfer pricing, followed by targeted discussions on the application of each step of the Measurement process to transfer pricing-related positions.

Accounting Policy & Practice Portfolios: Accounting for Income Taxes
Portfolio 5004-2nd: Accounting for Income Taxes: Uncertain Tax Positions in Transfer Pricing
Detailed Analysis
VI. Measurement Analyses

A. ASC 740-10 Requirements on Measurement

Each position that is recognized under ASC 740-10 must be measured. ASC 740-10-30-7 states the following:

> A tax position that meets the more-likely-than-not recognition threshold shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement with a tax authority that has full knowledge of all relevant information. Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon [effective] settlement using the facts, circumstances, and information available at the reporting date.

ASC 740-10's Measurement step addresses the “amount” question in that it provides specific guidance on how to quantify the tax benefit associated with any given UTP. This step requires the application of a framework that assesses management's estimates of what taxes the entity will eventually pay once the position is "effectively settled."

ASC 740-10 presents examples of how to identify the amount of tax benefit to recognize under the Measurement step. As illustrated in the measurement examples[71] in ASC 740-10, a company determines the amount of tax benefit to record by listing scenarios of possible estimated outcomes. The examples show these outcomes listed in a table that includes both the amount and the probability of that outcome in order of greatest to least tax benefit. Worksheet 3 of this Portfolio utilizes the example from ASC 740-10-55-103 to illustrate how scenarios can be assembled under the Measurement step. In Worksheet 3 illustrates the following concepts:

[71] ASC 740-10-55.

• *Possible Estimated Outcome* — Worksheet 3 shows the tax benefit (in dollars) associated with each UTP.

• *Individual Probability of Occurring* — A company then must identify the possible outcomes associated with each UTP and ascribe a probability to each. Worksheet 3 shows the probability (in percentages) of each outcome scenario occurring. These individual percentages are then summed to form the cumulative probability shown in the next column.

• *Cumulative Probability* — The cumulative probability approach is used to determine which scenario results in a cumulative probability of 50 percent or greater that may need to be recognized for ASC 740-10 purposes. Under this approach, the largest tax benefit which has a greater than 50 percent cumulative probability of being realized upon settlement with the tax authority is recognized.

As with the Recognition step, ASC 740-10 does not provide detailed guidance on how to approach the Measurement step for transfer pricing positions. Transfer pricing-related tax positions have unique characteristics compared to other tax positions that result in several challenges when applying ASC 740-10's requirements for this step. Common questions include:

• How can an MNE with hundreds, even thousands, of intercompany transactions, possibly perform a Measurement test on each Unit of Account without exhausting all of its internal resources?

• How does one identify scenarios for transfer pricing-related tax positions?

• How does one account for the fact that there are two tax authorities that are stakeholders in any one Unit of Account, each with different perspectives and motivations related to how a given transfer price should be calculated?

• How does one incorporate MAP, litigation and appeals processes, and other legal avenues when interpreting "effective settlement" for transfer pricing positions?

• Transfer pricing disputes can often involve setoffs between transactions. How does one take this into account under the Measurement step?

• How can probabilities be reliably assigned to different scenarios for transfer pricing outcomes, given the subjectivity involved in transfer pricing analyses?

The subsequent subsections of Section VI address each of the questions outlined above, further detail the analysis of scenarios as it relates to transfer pricing, and identify best practices for applying the Measurement step to transfer pricing positions.

B. Identifying Information Relevant to Analyzing Potential Exposures

ASC 740-10 is designed to communicate information about income tax exposures. When performing exposure analysis, it is helpful to review the following items for each UTP to assess the relative level of risk and potential adjustments based on the documentation available. Factors to review include:

- Type of Transaction[72]

[72] For a more detailed discussion about the nature of different transfer pricing transactions see 6908 T.M., *Transfer Pricing: Perspectives of Economists and Accountants (Part 1),* and 6909 T.M., *Transfer Pricing: Perspectives of Economists and Accountants (Part 2).*

- Audit History
- Transfer Pricing Documentation
- Intercompany Agreements
- Actual Charges Recorded
- Jurisdictions/Tax Authorities Involved
- APA
- Double Tax Relief under the MAP process
- Entity Profitability

Relevant information, such as that listed above, can be found through a variety of sources. For example, Schedule M of U.S. tax Forms 5471 and 5472, and their foreign equivalents, help identify all intercompany transactions that have occurred within the organization. Other internal sources of information may include transfer pricing reports, financial data, audit history of each location, and intercompany agreements, which are often overseen by foreign controllers, treasury, and accounting personnel.

Comment: Tax teams that prepare standardized templates and questionnaires report increased efficiency and accuracy in the information-gathering process. The information gathered in identifying the UTPs for transfer pricing purposes will also be used to assemble information for the U.S. Schedule UTP.

1. Type of Transaction —

The nature of an intercompany transaction significantly affects the relative risk of an adjustment. Business functions and the resulting profits associated with each side of an intercompany transaction can be characterized into either “routine” or “non-routine”. Routine transactions have characteristics that render them generally more straightforward to benchmark and often involve less of the uncertainty that often leads to significant discrepancies in the positions taken by the taxpayer and the tax authorities. Non-routine transactions generally involve higher “stakes” and more uncertainty, lending to increased probability of a substantial adjustment.

There are several characteristics that would result in a transaction being classified as routine.[73]

[73] Even routine transactions are subject to tax authority scrutiny. Tax authorities can question the characterization of a transaction, the costs associated with it, or the benchmarking.

- Routine transactions are easily identified. Routine transactions are transactions in which the risk of a transfer pricing challenge and complexity of the transaction is relatively low. For example, if a company has a contract manufacturer, the contract manufacturer will typically be viewed as a less complex party than other companies in the group and be characterized as routine within the intercompany supply chain.

- Costs for routine transactions are usually accurately captured. Using the contract manufacturer example, the costs incurred to manufacture and ship the product, whether to third parties or to unrelated parties within the business, are a routine part of any manufacturing business and companies typically have cost accounting systems dedicated to capturing these costs.

- Benchmarking is relatively straightforward. Third-party companies performing similar functions, bearing similar risks, and utilizing similar levels of assets can be identified using publicly available sources.

- Transactions occur regularly, year after year. To the extent that transactions occur under similar circumstances year after year, they are less likely to require special consideration.

- Transactions do not contain unique contributors of value. An example of this would be the intercompany sale of a commodity good when the price of that product is well established within public markets.

Transactions that are non-routine in nature generally involve transactions that have a high risk of transfer pricing challenge. These “non-routine” transactions involve unique products, services or intangibles; are more complex transactions; or concern an item that relates to the company's competitive advantage. Because these transactions relate to aspects of a company's key success factors or determinants of the company's overall profitability, they are often unique and much more difficult to benchmark with comparables analyses. This, plus other significant uncertainties involved in quantifying these transactions, can lead to material differences in perspectives between a taxpayer and tax authorities in how to determine an arm's length charge; this can result in significant transfer pricing exposures.

Comment: The nature of the transaction can have a material effect on how one analyzes both sides of a Unit of Account within an ASC 740-10 transfer pricing analysis.

Example: In the case study example in Worksheet 2, the taxpayer has tangible property transactions in which goods are sold from the United States and the United Kingdom to affiliated distributors in various non-U.S. jurisdictions (*see* Exhibit 2, Transactions 1 through 18). Because this transaction involves the physical sale of goods across borders, the goods are easily identified. The costs of manufacturing these products are normally captured as a routine part of the entities' accounting process. In the case study, a materiality threshold was agreed to with the company's auditors before the ASC 740-10 analysis. The materiality threshold requires the company to examine all intercompany tangible goods transactions that involve the U.S. headquarters entity with a cumulative transaction volume of greater than $5 million over a six-year period and all intercompany tangible good transactions that involve entities outside the United States with a cumulative transaction volume of greater than $1 million. In the case study, tangible property transactions 5 through 9 are eliminated from further analysis because the transaction amounts fall below the $5 million U.S. threshold and transactions 13 through 18 are similarly eliminated because transaction amounts fall below the $1 million non-U.S. threshold. The determination of whether each of these UTPs are within the threshold limits, agreed to in advance with the auditors, is noted within the column entitled “Exceeds Threshold” (*see* Worksheet 2, Exhibit 6). Because these transactions fall below the materiality threshold further analysis under detailed measurement testing is not required as noted in the column entitled “Proceed to Detailed Measurement” (*see* Exhibit 6).[74]

[74] See Section III.C.1. for additional considerations when determining materiality thresholds.

In contrast, the Case Study example in Worksheet 2 also includes royalties related to the license of intangible property from the United States to various non-U.S. locations (*see* Worksheet 2, Exhibit 3, Transactions 19 through 39). The risk profile for these types of non-routine transactions would typically be much higher. Because intangible transactions are more difficult to value, the case study in Worksheet 2 does not place a materiality threshold on these transactions and thus must each be analyzed for ASC 740-10.

2. Audit History —

A company's audit history with respect to a particular transaction needs to be considered in evaluating the overall risk of a potential adjustment, and it should be considered separately for each of the tax jurisdictions affected by the transaction. The importance of audit history is confirmed by ASC 740-10's requirement in ASC 740-10-25-7(b) that "the past administrative practices and precedents of the tax authority in its dealings with the enterprise … should be taken into account."

If the U.S. taxpayer has been recently audited by the IRS for a previous period and the outcome of the audit was to agree on an arm's length royalty rate that the U.S. entity should charge for the license of intangible property, then, assuming there were no material changes in any facts and circumstances related to the transaction, the risk of adjustment would be reduced if the taxpayer continued to charge the agreed-upon royalty. In contrast, if the taxpayer has never been audited, there may be a higher level of uncertainty around how the IRS would treat this transaction. In this case, one cannot rely on the audit history of the actual taxpayer but must review public documents and relevant court cases to determine how the IRS has approached these transactions. Audit history also applies equally to non-U.S. entities as well.

Example: In the case study in Worksheet 2, Exhibit 6, the intangible transactions between the U.S. headquarters entity and the Canadian distributor have been audited by the Canadian tax authorities for the years ended Dec. 31, 2022 through 2024 (*see* Transactions 25 through 27). The Canadian audit has been closed with no adjustment required to the transfer pricing related to intercompany royalties paid to the U.S. headquarters entity. For these transactions the taxpayer has agreed with its auditors that there is no requirement to proceed to the measurement stage for the Canadian transactions; however, because the transactions have not been reviewed by the IRS, further analysis is required to assess any UTPs related to the U.S. entity.

Comment: The functional, asset, and risk analyses, as well as the market and economic conditions upon which the audit was settled, must be re-evaluated as any changes in facts between an audit year(s) and subsequent years may render the audit-year arm's length settlement invalid for later years. Even if there have been no material changes in facts, a settlement agreement for a time audit period does not guarantee that the terms of the agreement will provide certainty for future years.

A significant example of the consequences of relying on a prior settlement, but not re-evaluating the functional, assets, and risks analysis upon which the audit was settled, can be found in the case of *Coca-Cola Co. v. Commissioner*.[75] The transaction under dispute in this case was the royalty paid to the U.S. parent for intangible property related to the manufacture, distribution, and sale of the Coca-Cola branded products by foreign affiliates for the years 2007–2009. As part of its defense of the transfer pricing for this transaction, Coca-Cola referred to its settlement with the IRS for the tax years 1987–1995, in which Coca-Cola and the IRS had agreed to a methodology for determining the transfer pricing for the same transaction. Coca-Cola consistently applied this methodology to determine the transfer price of this transaction for each year through 2009. At trial, Coca-Cola argued that the IRS was bound by the terms of the earlier settlement agreement.

[75] *Coca-Cola Co. v. Commissioner*, 155 T.C. No. 10 (2020).

However, the Tax Court found that the provisions within the settlement agreement did not address the question of what transfer pricing methodology should be used for years after 1995. Rather, it found only that the agreement prevented the IRS from imposing transfer pricing misstatement penalties if Coca-Cola used the settlement methodology.

Once the Tax Court determined that the IRS was not bound by the earlier settlement agreement for years after 1995, it turned to an analysis of the IRS proposed adjustments. In its Findings of Facts, the court determined that Coca-Cola's operations and supply chain were significantly different in the audit years than they were during the 1987–1995 time period.[76] As a result, the transfer pricing methodology of the settlement agreement was no longer applicable, and the IRS was free to develop an alternative approach.[77]

[76] *Coca-Cola Co. v. Commissioner*, 155 T.C. No. 10 (2020), *Findings of Fact*.

[77] As of the writing of this Portfolio, Coca-Cola has stated its intention to appeal the Tax Court decision to the Eleventh Circuit.

Comment: In addition to ensuring that a prior audit resolution or court decision is still applicable in later years, it is important to examine a transaction from the perspective of both tax authorities. One tax authority having reviewed and agreed to the transfer pricing does not necessarily mean that exposure does not exist from the tax authority that has not reviewed the transfer pricing for that transaction.

3. Transfer Pricing Documentation —

The existence, completeness, and quality of transfer pricing documentation factors into the identification and evaluation of transfer pricing exposure. The United States and many non-U.S. jurisdictions have enacted transfer pricing documentation requirements and penalty regimes. In some tax jurisdictions, penalties would apply for failing to meet the documentation requirements. In others, such as in the United States, penalties can only be assessed in the case of a tax adjustment, but a taxpayer may be able to avoid certain transfer-pricing-related penalties if it satisfies that jurisdiction's transfer pricing documentation requirements.[78]

[78] For example, in the United States, substantial and gross valuation misstatement penalties are defined under IRC §6662(a), I, and (h), which can apply whenever there is an underpayment of tax attributable to a valuation misstatement, subject to certain thresholds. These penalties can be avoided if the taxpayer meets the reasonable cause and good faith exception under IRC §6664(c) . Reg. §1.6662-6(c)(6) provides that a taxpayer will be treated as having reasonable cause under IRC §6664(c) if the taxpayer meets the contemporaneous documentation requirements of Reg. §1.6662-6(d).

The existence of transfer pricing documentation alone does not remove the risk of transfer pricing penalties, as the documentation must be found to meet the standards for penalty protection purposes. To qualify for transfer pricing penalty protection in the United States, the IRS requires that the report provided meet the contemporaneous transfer pricing documentation requirements set out in Reg. §1.6662-6(d)(iii). In general, this means that the submitted documentation must be able to adequately and clearly answer the “who, what, when, where, why, and how” of the intercompany transactions documented, as well as the reasonable selection and application of a transfer pricing method.[79]

[79] IRS, *The Section 6662(e) Substantial and Gross Valuation Misstatement Penalty,* “A Presentation and Tutorial Guide of the Code and Regulations,” https://www.irs.gov/pub/irs-apa/penalties6662_e.pdf.

In 2020, the IRS published its view on Transfer Pricing Documentation Best Practices, where it notes that adequate documentation allows the examining agent to rely on the taxpayer's statement of facts and analysis of the intercompany transactions, leading to reduced chance that the issue will be further examined or a more efficient audit if the issue is examined. Recommended best practices include (among others):[80]

[80] IRS.gov, Transfer Pricing Documentation Best Practices Frequently Asked Questions (FAQs). https://www.irs.gov/businesses/international-businesses/transfer-pricing-documentation-best-practices-frequently-asked-questions-faqs.

• Performing a Self-Assessment — The IRS lists potential indicators of transfer pricing non-compliance and recommends that taxpayers review their transfer pricing documentation against such parameters. This includes conducting a sensitivity analysis around the best method selection and application, selection and comparison of profit level indicators used to calculate both tested party and third-party comparable results, and allocation of the multinational group's profits and whether such allocations are reasonable based on each party's relative contribution to that profit.

• Demonstrate compliance with Section 482 and the regulations thereunder — The IRS recommends a thorough analysis of the taxpayer's application of IRC §482 and the regulations thereunder in addition to its analysis and assessment of the arm's length nature of its intercompany transactions. For example, with respect to using third-party comparables to benchmark the arm's length nature of a transaction, this would include an explanation of the basis for selecting certain comparables and eliminating others and the reasoning behind comparability adjustments.

• Ensuring documentation meets the IRS's usefulness criteria — When preparing documentation, taxpayers should be mindful to include the following: (i) full explanation of the data used in the analysis; (ii) descriptions of the general business risks of the transactions and then more detailed descriptions of how these risks are allocated among the controlled participants to the transaction based on the intercompany policies/agreements; (iii) allocation of profits among all parties; (iv) functional and risk analysis for each transaction; (v) analysis of special business circumstances that may have affected profitability; and (vi) description of challenges of the analysis (e.g., allocation of losses).[81]

[81] IRS.gov, Transfer Pricing Documentation Best Practices Frequently Asked Questions (FAQs). https://www.irs.gov/businesses/international-businesses/transfer-pricing-documentation-best-practices-frequently-asked-questions-faqs.

The evaluation of transfer pricing documentation also should address the issue of timeliness. First, the report should have been prepared contemporaneously as required under Reg. §1.6662-6(d)(iii)(A), meaning that the report was substantially complete at the time that the company's annual tax return was filed. If the study was performed subsequent to the filing of the tax return it may assist in evaluating the reasonableness of the transfer pricing position taken but may not protect the taxpayer from potential penalties if an adjustment is proposed by the IRS.[82] Second, taxpayers must consider how much time has passed since the report and analysis was prepared. If a company's operations changed considerably over time and the transfer pricing report was not updated for these changes, the report may no longer be an indicator of the arm's length pricing for the transactions. Comparable financial information (if applicable) could also become outdated.

[82] Reg. §1.6662-6(d)(2)(iii)(A) states that with the exception of the documentation described in paragraphs §§*1.6662(d)(2)(iii)(B)(9)* and *(10)*, documentation must be in existence when the return is filed. In addition, other countries also provide for the application of penalties, either in the case of an adjustment or when documentation filing requirements are not met.

On January 12, 2018, the IRS issued a *Memorandum for Large Business and International Division Employees*, that noted that the "regulations require the IRS to apply penalties when the taxpayer fails to create or to timely provide §§ 6662(e) documentation or when the IRC §6662(e) documentation provided is unreasonable or inadequate, assuming the net adjustment penalty thresholds are met."[83] Specifically, the IRS states:

[83] *LB&I-04-01-0118-003*.

> Having IRC §6662(e) documentation does not automatically protect against penalties. The IRC §6662(e) documentation must also be assessed for adequacy and reasonableness. To meet the reasonable cause exception of the penalty regulations, taxpayers must document they reasonably selected the best method for their analysis and they reasonably applied that best method.

As indicated above, the adequacy and adherence to Reg. §1.6662-6(d)(iii) will have an impact as to the likeliness of penalties and measurement of potential transfer pricing exposure for ASC-740 purposes.

Example: The case study in Worksheet 2, Exhibit 5 includes intercompany loan transactions between a U.S. headquarters entity and a U.K. related entity for the years ended Dec. 31, 2002 through 2007 (*see* Transactions 66 through 71). With no transfer pricing report to support these transactions, the risk of adjustment increases. The case study concludes that these transactions should be reviewed as part of the detailed measurement step. Transaction 70 does not require further analysis because the statute of limitations for these audit years has expired in both jurisdictions (the United States and the United Kingdom). Transaction 71 does not require further review from the U.K. perspective because the taxable year is no longer open within the United Kingdom but remains open for U.S. transactions. Therefore, Transaction 71 is subject to further review from the U.S. perspective.

In November 2018, the IRS issued Publication 5316 (Rev. 11-2018), presenting findings that penalties were not consistently applied in instances where taxpayer documentation may have fallen short of meeting the requirements of Reg. §1.6662-6(d)(iii). Since that time, the IRS has reiterated its focus on more consistently applying IRC §6662 penalties in instances in which documentation was found to be inadequate. At the Tax Executives Institute Seminar on September 20, 2022, the IRS Transfer Pricing Practice Director of Field Operations acknowledged that the IRS was not doing enough to assess penalties where "documentation reports are not sufficient and not reasonable."[84] Later that same year, the LB&I Division Commissioner stated that the IRS continues to "look more closely at cases, even those with transfer pricing documentation, to determine when it's appropriate to assert penalties."[85]

[84] Bloomberg Tax, Tax Management International Journal, 07/06/2023. Transfer Pricing and §6662 Penalties: The IRS Means It This Time. Steven C. Wrappe and Nina M. Nelson. Grant Thornton LLP. September 12, 2023.

[85] Bloomberg Tax, Tax Management International Journal, 07/06/2023. Transfer Pricing and §6662 Penalties: The IRS Means It This Time. Steven C. Wrappe and Nina M. Nelson. Grant Thornton LLP. September 12, 2023.

Comment: In an environment of increased scrutiny and enforcement of transfer pricing penalties, it is important for taxpayers to ensure that their transfer pricing documentation meets the requirements of Reg. §1.6662-6(d)(iii) for adequacy and timeliness to avoid being assessed penalties which could be substantial.

To the extent that the documentation is unclear or poorly presented, the likelihood increases that the IRS will conduct its own analysis and question the positions taken within the original study. Again, if the IRS is conducting its own analysis rather than evaluating the positions taken in an existing study, then there is increased uncertainty as to how it will conclude on the underlying transactions. For ASC-740-10 purposes, this impacts the identification and measurement of a potential exposure.

4. Intercompany Agreements —

The existence of intercompany agreements is a factor that should be considered in evaluating the taxpayer's risk profile with respect to potential transfer pricing adjustments. Intercompany agreements document the intention of the parties with respect to how they are to interact and formalize the terms of the transfer pricing arrangements. While they are not negotiated contracts between two unrelated parties, they do describe the responsibilities of each of the parties and the allocation of risks, along with the governing intercompany pricing policy.

In its Transfer Pricing Documentation Best Practices FAQs, the IRS states that risk analysis should be consistent with intercompany agreements. That is, intercompany agreements and the assignment of rights and responsibilities between the parties generally establish how risks are allocated. Per Reg. §1.482-1(d)(3)(ii)(B):

> The allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance.

Reg. §1.482-1(d)(3)(ii)(B) provides the following factors to consider when determining whether a transaction has economic substance:

- Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have been modified accordingly;

- Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

- The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

This is consistent with the guidance provided under the OECD Transfer Pricing Guidelines regarding the contractual terms of intercompany agreements.[86] However, intercompany agreements are only reliable support if they are consistent with how the company actually operates.[87]

[86] The 2022 OECD Transfer Pricing Guidelines note that written contracts alone are unlikely to provide all the information needed to perform a transfer pricing analysis. Instead, it must be shown that the contractual terms of the agreement reflect the economic substance and actual conduct of the parties to the transaction. *See* 2022 OECD Transfer Pricing Guidelines, D.1.1., Paragraph 1.42.

[87] Note that Reg. §1.482-1(d)(3)(ii)(B)(1) states that contractual terms will be respected if consistent with economic substance of transactions.

Example: In the case study example in Worksheet 2 (*See* Exhibit 6, Transaction 62) the U.S. headquarters has contracted with its related party in China to provide intercompany research and development services for which there is no intercompany agreement. The lack of an intercompany agreement could signal a significant transfer pricing exposure for that Unit of Account. This is because some countries such as China may deny the deductibility of a charge completely if no agreement is in place.

The existence and strength of a company's intercompany agreements will have an impact on the identification and measurement of transfer pricing exposure for ASC-740 analysis.

Comment: The IRS Internal Revenue Manual, Part 4, Chapter 61, Section 3 directs the IRS issue team on an audit to “request and perform a review and analysis of relevant intercompany agreements.” The issue team is further directed to collaborate with LB&I Field Counsel to understand the legal terms and content of intercompany agreements.[88] To the extent that the company's actions are inconsistent with the underlying agreements (i.e., lack economic substance as detailed above, or actual assumption of risks is in conflict with the agreement), the agreements themselves are of little use against a potential transfer pricing adjustment and could possibly damage the company's position either by highlighting that the company is not operating in accordance with the originally agreed-upon procedures or providing a fact pattern that is contrary to the company's current transfer pricing practices. This may result in the IRS developing its own evaluation of the functions performed, risks assumed and assets owned by the related entities, apart from what is stated in the agreement, which may in turn give rise to substantial proposed adjustments to the transfer price and assessment of penalties.

[88] IRM 4.61.3.4.4(9) (01-09-2023).

As with the guidance provided to the issue team, taxpayers are similarly advised to consult their legal counsel to ensure understanding of the full ramifications of the language used within an intercompany agreement. Best practices for intercompany agreements include:

• Executing an intercompany agreement before the commencement of the intercompany activity being documented — Reg. §1.482-1(d)(3)(ii)(B) explicitly mentions the expectation that the contractual terms be “agreed to in writing before the transactions are entered into.” Similarly, the OECD Transfer Pricing Guidelines emphasizes that “the assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialization of risk outcomes … The purported assumption of risk by associated enterprises when risk outcomes are certain is by definition not an assumption of risk, since there is no longer any risk.”[89]

[89] 2022 OECD Transfer Pricing Guidelines, Section D.1.2.1.2, Paragraph 1.78.

• Including key terms and conditions within the intercompany agreement — These terms and conditions could include (but are not limited to) the effective date, initial terms of the agreement and process or options for renewal, jurisdiction under which the intercompany agreement is governed and the territory(ies) in which the intercompany activity is relevant, pricing and payment terms, legal ownership of any intellectual property, etc. While third-party agreements may be helpful as a starting point, it is important to review such terms and conditions before including them, as certain areas included in third-party agreements would not be possible or practical for related parties to follow.

• Ensuring that the parties to the agreement will follow the terms and conditions of the intercompany agreement in practice — It is important that the parties to the agreement are able to be shown to be following the terms and conditions set forth in the intercompany agreement. Therefore, it is important to consider any provisions set forth within the agreement and determine whether or not it is likely that a company will be able to follow them. For example, if under a contract manufacturing agreement, there is a provision that the contract manufacturer will provide detailed cost schedules in writing every quarter, the company will need to have such cost schedules available to provide in the event of an audit. Best practice is for multinational enterprises to prepare a transfer pricing statement and operations manual that translates its transfer pricing policies into implementation steps. It is important for the actual transfer pricing implementation to follow the terms and outlined procedures in the intercompany agreement.

• Alignment with other transfer pricing documents and statements of fact — The intercompany agreement is one of many possible documents used to support a taxpayer's transfer pricing policies. As such, it is important to provide consistency across all documents and workpapers. For example, transfer pricing calculations should follow the methodology specified in the intercompany agreement and the statement of facts (e.g., roles and responsibilities, ownership of IP, etc.) should not be contradicted either in transfer pricing documentation reports, on the company's website, or other sources of company information (e.g., annual reports).

• Alignment with the arm's length standard — When setting the terms and conditions of an agreement, it is important to consider whether an unrelated party would agree to certain terms. For example, an unrelated party is unlikely to execute an agreement that does not have a clear termination clause or explicit pricing for the transaction. If the parties do not transact in a manner that is consistent with how unrelated parties would transact under similar facts and circumstances, the transaction will likely not be considered arm's length and thus may draw scrutiny from tax authorities.

In summary, it is important that intercompany agreements accurately reflect the current roles, responsibilities, allocation of risk, and terms of the intercompany transaction in practice. To the extent any changes arise over time in the way the parties to the intercompany agreement interact with each other, such changes should be reflected in an updated or amended intercompany agreement.

5. Actual Charges Recorded —

The actual charges recorded by a company are critical to understanding potential audit risk. If actual charges for an intercompany transaction for a specific tax year are inconsistent with a company's transfer pricing policies or documentation, this significantly reduces the credibility of a company's position. In contrast, a company that follows a well-documented process to ensure that its transfer pricing policies in place are maintained in accordance with intercompany agreements and underlying transfer pricing studies significantly reduces its exposure to risk of an adjustment by a tax authority.

Example: In the example in Worksheet 2, Exhibit 3, Transactions 31 through 36 represent licenses of intangibles from U.S. HQ Inc. to manufacturers in China and Brazil for which no intercompany royalty has been recorded. Despite the fact that each of these entities has a thorough transfer pricing analysis to support the company's global transfer pricing *policies*, the reports do not document the actual *results*. This could create a significant risk of a transfer pricing adjustment for each of these entities and, as such, requires further analysis.

Comment: TP Policy Statements and associated evidence of an implementation plan can be useful in bridging the gap between the transfer pricing policy and implementation of that policy into the company's financial statements.

6. APA —

APAs allow a taxpayer to establish a prospective agreement with tax authorities on the transfer pricing methodology for an intercompany transaction (generally for five years and potentially renewable). As it relates to evaluating exposures under ASC 740-10, successfully completing a bilateral APA, and following the terms of that APA, can mitigate the uncertainty of how the relevant tax authorities will assess a company's transactions that are covered for the period under the APA. Note that some APAs require transfer pricing adjustments in each year of the covered period, but some only require a transfer pricing adjustment in the final year of the APA.[90] This may complicate the ASC 740 analysis in the non-final years of the APA. Also, completing a unilateral APA only provides certainty on one side of the transaction while the other side of the transaction, not covered by the APA, requires further analysis.

[90] Announcement and Report Concerning Advance Pricing Agreements, March 26, 2024, pp.10–11. https://www.irs.gov/pub/irs-drop/a-24-16.pdf, accessed August 30, 2024.

7. Mutual Assistance Procedures —

MAP and arbitration forums, as agreed to between tax treaty partners, allow companies to seek relief from double taxation involving intercompany transactions. In evaluating potential exposures under ASC 740-10, the company's history as well as its willingness and ability to enter into MAP on issues resulting in double taxation needs to be evaluated in determining whether further analysis is required.

8. Entity Profitability —

Entity profitability needs to be considered in evaluating transfer pricing exposure under ASC 740-10. The intercompany pricing between two related entities will ultimately affect the allocation of profits between these entities and the taxable income available within their respective jurisdictions. The resulting profitability of an entity after intercompany pricing has been applied will typically be a focal point of a tax authority audit, particularly if the entity in that tax authority's jurisdiction has been reporting losses over time. Similarly, entity profitability should be taken into account under ASC 740-10.

Example: In the example in Worksheet 2, Exhibit 6, Transactions 10 through 12 represent the sale of tangible property from a U.K. manufacturer to a limited risk Dutch distributor in which the Dutch distributor is consistently earning annual operating losses (operating losses defined as losses before interest and taxes). For these transactions, the Dutch tax authorities are more likely to question the underlying transactions under an audit. As a result the case study recommends further analysis for these transactions.

In its September 2020 publication on the Transfer Pricing Examination Process, the IRS directs examination teams to develop a risk assessment with specific items to take into consideration. Two of these items highlight the importance placed on entity profitability in the calculation of risk: (a) Worldwide effective tax rate, profitability, and whether the taxpayer's overall tax position benefits from income shifting from a financial accounting/cash flow standpoint; and (b) Net operating losses (NOLs).[91] Furthermore, the IRS specifically lists the “total profits or losses associated with each material controlled transaction and each controlled party's share of the total profits or losses” to be included in the transfer pricing/supply chain orientation meeting requested during the Execution Phase of an audit.[92]

[91] Irs.gov, Publication 5300 (Rev. 09-2020), *Transfer Pricing Examination Process.*

[92] Irs.gov, Part. 4, Chapter 61, Section 3 — Development of IRC 482 Cases. 4.61.3.4.4 (01-09-2023), (5)f. https://www.irs.gov/irm/part4/irm_04-061-003.

If non-U.S. distributors are earning significant operating profits after the application of all intercompany charges, this will reduce the exposure to transfer pricing adjustments from non-U.S. tax authorities. However, depending on how significant the distributor profits are, this may increase the possibility that the IRS will focus on this issue and look for explanations as to why profits of the non-U.S. distribution entity(ies) are so high. It is important for taxpayers to review legal entity profitability in the context of the broader global group and assess whether the functions, assets, and risks attributable to each entity are aligned with the profit assigned to it. However, in conducting this risk analysis, it is also important to be cognizant of the fact that profits are influenced by more than just intercompany pricing. Operational or market factors that may cause deviations between the intercompany price and expected profitability need to be identified and documented.

On the other hand, if a U.S. distributor is reporting losses, this will increase the exposure to a U.S. tax adjustment.[93]

[93] *See* Section IV.B.2.

Comment: A company that develops documentation (either within a transfer pricing report or separate memo) identifying the reasons for losses or low-margin results may be reducing its potential for an audit adjustment, as it has documented the reasons for the results before the IRS or other tax jurisdictions has raised the issue. Along with a historical discussion explaining the profitability shown by the legal entity in question, taxpayers should also address, if feasible, the forecast for potential profits in future years given the functions and risks of the parties. Tax examiners are likely to focus on ensuring that the losses are not perpetual or caused by non-arm's length transfer pricing policies. Reg. §1.6662-6(e) sets forth special rules for carrybacks and carryovers when calculating a transfer pricing adjustment penalty in the case of a net operating loss:[94]

[94] The Section 6662(e) Substantial and Gross Valuation Misstatement Penalty, *A Presentation and Tutorial Guide of the Code and Regulations.* https://www.irs.gov/pub/irs-apa/penalties6662_e.pdf.

> If there is a substantial or gross valuation misstatement for a taxable year that gives rise to a loss, deduction or credit that is carried to another taxable year, the transactional penalty and the net adjustment penalty will be imposed on any resulting underpayment of tax in that other taxable year. In determining whether there is a substantial or gross valuation misstatement for a taxable year, no amount carried from another taxable year shall be included.

In other words, to the extent the magnitude of the adjustment would give rise to a penalty, but there is technically no underpayment of tax (since the taxpayer continues to report a loss) for that year, that penalty would be assessed in the next year in which the taxpayer reports taxable income. However, for the purposes of assessing whether or not an adjustment constitutes a “substantial or gross valuation misstatement” in any given taxable year, only that year's adjustment will be taken into consideration (i.e., the adjusted amounts are not cumulative).

Case 9 and 10 of the IRS guidance on the application of 6662(e) penalties referenced above provide examples regarding the calculation of penalties in the event of NOLs.[95]

[95] The Section 6662(e) Substantial and Gross Valuation Misstatement Penalty, A Presentation and Tutorial Guide of the Code and Regulations. https://www.irs.gov/pub/irs-apa/penalties6662_e.pdf.

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C. Use of and Framework for Preliminary Test

Once initial filters have been applied, the remaining pool of UTPs to be analyzed may still be large. In that case, it would be impractical to develop scenarios and perform cumulative probability calculations for each individually. However, a company may know that many of its remaining UTPs have very little exposure (e.g., highly certain positions), and that no unrecognized tax benefit should be associated with them. In these cases, companies have found it helpful to develop a “Preliminary Test”. This involves the company and its auditor developing a list of factors by which to evaluate the arm's length nature of each intercompany transaction being reviewed. The factors would be defined such that, if a UTP satisfied all of the factors and “passed” the Preliminary Test, then the company and auditor would agree that the probability of the previously recorded charge being sustained upon examination in the relevant jurisdiction(s) is greater than 50 percent. The benefit of this approach is that the application of this Preliminary Test would take less time than developing scenarios and performing cumulative probability calculations for each UTP.

Comment: The factors[96] used for a Preliminary Test depend on the facts and circumstances of the company. Some of the factors that can be used to develop a screen of the arm's length nature of a UTP include:

[96] Note that these factors closely align with the items that are relevant to identifying exposures as noted in Section VI.B. of this Portfolio.

1. Audit history related to the intercompany transaction;

2. The nature of available transfer pricing documentation covering that UTP;

3. Whether the actual charge was consistent with the methodology and arm's length range for that UTP;

4. Whether an intercompany agreement was in place for that UTP; and

5. Whether the pre-tax income of the entity involved in that UTP was positive or negative for the year in which the UTP took place.

Additionally, the usefulness of the Preliminary Test concept highly depends upon the level of detail required by the company's auditors. This concept is not found anywhere in ASC 740-10; it is merely a convention that has been applied by companies and auditors to make the application of the ASC 740-10 Measurement step feasible for companies with large numbers of UTPs related to transfer pricing.

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D. Defining Scenarios for Transfer Pricing

One of the challenging aspects of an ASC 740-10 analysis involving transfer pricing positions is proving that scenarios incorporated into a cumulative probability analysis are objective and comprehensive. UTPs related to transfer pricing could produce limitless possible outcomes, so how can one be sure that the scenarios chosen to be applied are appropriate?

ASC 740-10 itself does not specifically address how to develop scenarios. ASC 740-10-30-7 states “Measurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon [effective] settlement using the facts, circumstances, and information available at the reporting date.”[97] In other words, companies must consider the relevant tax authorities’ likely position on the UTP and how that would impact its arm's length price. While this should be the general guideline for any scenario considered, how it is applied in practice is not clearly defined.

[97] ASC 740-10-30-7.

ASC 740-10 refers to examples in paragraphs ASC 740-10-55-81 through 55-229 but they provide limited guidance on how scenarios are to be developed for transfer pricing. ASC 740-10-55-99 through 55-101 deal with “Highly Certain Tax Positions, ” and demonstrate that it is not necessary to develop scenarios for these situations.

Given that ASC 740-10 does not provide specific instructions for developing scenarios, companies must rely on best practices, literature, or other authoritative support for guidance. Section VI.D. of this Portfolio describes in detail some best practices for completing this step. However, there is by no means only one clear approach to developing scenarios in the cumulative probability analyses, and company management must be able to articulate how the approach taken provides objective, accurate results that represent the best estimates of reserves needed for these UTPs.

1. Restrictive Assumptions —

ASC 740-10 requires that one make several assumptions in determining tax benefits, including:

- Each position will be subject to audit;
- No netting or trading of issues;
- All parties have equal access to information; and
- A determination of whether a position will be sustained under examination based on the technical merits of such position.

Before the promulgation of the rules in ASC 740-10, any one of these assumptions may or may not have been incorporated into a company's tax reserve calculations. In fact, a common practice before these rules took effect was to evaluate tax benefits based on a concept called “settlement value.” Settlement value typically took into consideration the probability that the auditor would identify the issue as well as other issues as part of the audit examination and reach an overall settlement amount.

This practice of arriving at an estimated overall settlement value has been eliminated under ASC 740-10, which requires a comparison for each separate UTP between what was recorded on a tax return and what would be realized upon effective settlement assuming the UTP was audited by all relevant tax jurisdictions.[98]

[98] The concept of “settlement value” is not to be confused with the term “effective settlement” used in identifying estimated outcomes of an uncertain tax position under ASC 740-10. The former refers to the concept of taking into account audit lotteries, which is not allowed under ASC 740-10. The latter reflects the specific guidance about how to quantify the amount to be recognized in financial statements under the Measurement step of ASC 740-10.

2. Considerations Regarding Scenarios for Transfer Pricing —

When ASC 740-10 was first implemented many companies and transfer pricing practitioners asked whether an ASC 740-10 analysis of a particular transaction would simply consist of probabilities assigned to the different quartiles and median of the arm's length range that the company had identified for that transaction. For example, if a company charged a royalty of 7 percent of net sales and internal comparables provide support for a range between 5 percent to 10 percent, with a median of 7 percent, this approach would assign probabilities to an adjustment to 5 percent, an adjustment to 10 percent, and a status-quo scenario of 7 percent, and disregard all other scenarios.

This may not be an appropriate way to approach an analysis since this implies that a tax authority and the company would be in agreement about the transaction characterization, the methodology used, the comparables identified, and all other relevant factors, and that any dispute would simply be about which point in the company-identified range was most appropriate. In fact, generally speaking, transfer pricing adjustments are not made to move a transaction from one point to another in an agreed arm's length range. Reg. §1.482-1(e)(1) states, “A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).” Rather, tax authorities are more likely to challenge any (or all) of the different aspects of a company's transfer pricing analysis, as listed above, to generate an adjustment.

The following subsections discuss several items that should be considered in developing alternative scenarios (i.e., expected outcomes) for any given transfer-pricing-related Unit of Account. It is important to note that many countries' transfer pricing documentation requirements specify that a taxpayer consider these same factors when preparing documentation for penalty protection.

a. Evaluation of Alternative Methods —

In developing scenarios, alternative transfer pricing methods should be considered. The selection of an appropriate transfer pricing method can be subjective, and different methods can yield significantly different results. Therefore, it is not uncommon for tax authorities to challenge the methodologies applied by a taxpayer, and such potential challenges should be considered when developing scenarios if company management believes this to be a material risk under audit. Such an analysis will be dependent on the geographic location of the parties relevant to the UTP, as each jurisdiction may have different rules and methods to analyze an intercompany transaction. For example, a UTP may involve a transaction in which one or more third-party license agreements were used (CUT methodology) to evaluate the arm's length nature of a royalty paid by licensee using U.S-developed intangible property. During the audit process, however, the IRS may reject the CUT methodology and determine that the best method is instead the CPM applied to the non-U.S. licensee. Use of the CPM is likely to provide a different outcome than the CUT-based price.

b. Comparables Selection —

After the transfer pricing methods have been examined, a careful evaluation of the comparables used to develop an arm's length range of results for each UTP needs to be performed. In an audit by the tax authorities, comparables are evaluated based on their comparability to the tested transaction or in the case of ASC 740-10, a UTP. In the United States, Reg. §1.482-1(c)(2)(i) specifies that the relative reliability of the transfer pricing method used (and thus, by extension, the transfer pricing analysis itself) depends on the following:

> … the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in §1.482-1(d)(3) (Factors for determining comparability), and after making adjustments for differences, as described in §1.482-1(d)(2) (Standard of comparability)

c. Characterization of Transactions —

There is a possibility that under audit the tax authority would dispute the characterization of a particular intercompany transaction, re-characterize it, and reach a different conclusion regarding the arm's length result. The risk of re-characterization of transactions needs to be evaluated at this phase of an ASC 740-10 analysis. For example, a taxpayer may characterize a controlled distributor as limited risk because it believes that its functions are routine, and its assets and risks are minimal. However, a tax authority may instead characterize the entity as a full distributor because it perceives the functions, assets, and risks to be more complex than does the taxpayer. Whether the entity is characterized as a limited risk distributor, or a full distributor will impact the comparables selected and ultimately the arm's length range of results indicated by those comparables.

d. Considering Both Sides of a Transaction —

A unique characteristic of tax uncertainties related to transfer pricing is that in almost all cases more than one tax authority must be satisfied to avoid an adjustment. For this reason, the expected outcomes related to any given Unit of Account must consider "both sides of the transaction," meaning the perspective of the tax authorities in both jurisdictions whose taxable income is affected by that transaction.

(1) Asymmetries Between Transfer Pricing Requirements —

In evaluating transfer pricing positions, the general standard to which most tax jurisdictions around the world adhere is the arm's length standard. Many countries have established separate transfer pricing rules and regulations generally based upon the OECD Transfer Pricing Guidelines. However, asymmetries continue to exist between the transfer pricing rules developed within various countries that need to be addressed when conducting an ASC 740-10 analysis.

This Portfolio, which is focused on application of ASC 740-10 to transfer pricing does not specifically examine the rules of countries other than the United States. However, when conducting a transfer pricing analysis for ASC 740-10, both sides of each intercompany transaction must be considered and the relevant transfer pricing rules and regulations for each jurisdiction affected by the intercompany transaction must be incorporated into the analysis.[99]

[99] *See* 6900 T.M., *Transfer Pricing: The Code, the Regulations, and Selected Case Law* and 6908 T.M., *Transfer Pricing: Perspectives of Economists and Accountants (Part 1),* discuss the application of the arm's-length standard within the United States, while Portfolio 6936 T.M., *Transfer Pricing: OECD Transfer Pricing Guidelines,* discusses the application of the OECD Transfer Pricing Guidelines. For a detailed description of transfer pricing rules and regulations for individual countries, refer to Portfolios 6940 T.M., 6945 T.M., 6950 T.M., 6955 T.M., 6960 T.M., 6965 T.M., 6970 T.M., 6975 T.M., *Transfer Pricing: Rules and Practice in Selected Countries.*

(2) Differing Rules on Acceptable Methodologies —

As described in Section III of this Portfolio, because a Unit of Account by definition involves two tax jurisdictions, the analysis requires separate consideration of potential audits by both jurisdictions. Therefore, an evaluation of potential adjustments to a company's intercompany pricing positions under an ASC 740-10 analysis is a multi-jurisdictional exercise. This may give rise to differences in the definition and application of certain transfer pricing methodologies.

(a) Selection of Method —

In the United States, Reg. §1.482-1(c) provides that “the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result.” Both the U.S. transfer pricing rules and the OECD Transfer Pricing Guidelines provide a list of methods that can be used to evaluate the arm's length nature of an intercompany transaction. The U.S. transfer pricing regulations provide a listing of specified methods (in addition to the option of applying an unspecified method) for evaluating arm's length pricing for intercompany transfers of tangible and intangible property, the provision of intercompany services, and other transactions (e.g., loans or advances, cost sharing, etc.).[100] Similarly, Chapter 2, Section A, ¶2.2 of the 2022 OECD Transfer Pricing Guidelines refers to the selection of a transfer pricing method, “finding the most appropriate method for a particular case … [and] should take account of the respective strengths and weaknesses of the OECD recognized methods.”[101]

[100] Reg. §1.482-2 (Determination of taxable income in specific situations), Reg. §1.482-3 (Methods to determine taxable income in connection with a transfer of tangible property), Reg. §1.482-4 (Methods to determine taxable income in

connection with a transfer of intangible property), Reg. §1.482-7 (Sharing of costs); and Reg. §1.482-9 (Methods to determine taxable income in connection with a controlled services transaction).

[101] OECD Transfer Pricing Guidelines, Chapter 2, Section A, ¶2.2.

From an ASC 740-10 perspective, consideration of both the U.S. and OECD methods (or local country regulations, as applicable) should be analyzed to determine the most appropriate method to support the arm's length nature of the tested transaction.

(3) Differing Perspectives on Calculating Arm's Length Ranges

(a) Inconsistent Use of Interquartile Ranges —

When it is not possible to perform adjustments to a set of comparables for material differences between the comparables and the taxpayer's intercompany transaction, Reg. §1.482-1(e)(2)(iii)(B) indicates that in “such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all the uncontrolled comparables so selected.”

One such method identified within the U.S. transfer pricing rules is an interquartile range, which narrows the overall set of comparables identified by limiting the “range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables.”[102] While Chapter 2, Part III, Section B.3, ¶2.79 of the 2022 OECD Transfer Pricing Guidelines indicates that “the use of a range may to some extent mitigate the level of inaccuracy,” the Guidelines do not specifically address the use of interquartile ranges beyond noting that “… if the range includes a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g. the interquartile range or other percentiles) might help to enhance the reliability of the analysis.” Further, the U.S. regulations and OECD calculate the interquartile range in slightly different ways, which can have an impact in marginal cases and determine whether a transfer price falls within or outside the established range.

[102] Reg. §1.482-1(e)(2)(iii)(C).

Some countries will not accept the use of an interquartile range in establishing an arm's length range for comparison to the tax position taken by the taxpayer. For example, in Canada, CRA tends to look at the full range of results from the most recent single year and selects a single point within the range that provides the most reliable result. CRA typically expects companies to target actual results that are at or close to the median of the full single-year range.

For purposes of applying ASC 740-10, it is important to be aware of these differences and to recognize that certain jurisdictions have different approaches to calculating a range. Therefore, in assessing the likelihood of the tax authorities accepting a range of comparables, it is important to consider specific local country nuances regarding the probability of the tax authorities selecting a point within the range that is above or below the position taken by the taxpayer.

(b) Inconsistencies in Use of Multi-Year Averages —

Reg. §1.482-1(f)(2)(iii)(A) indicates that data from “one or more years before or after the [taxable] year under review” may be appropriate for purposes of determining true taxable income of a controlled taxpayer in certain circumstances. Similarly, Chapter 3, Section B.5, ¶3.75 of the OECD Transfer Pricing

Guidelines indicates that "multiple-year data is often useful in a comparability analysis, but is not a systematic requirement." However, in certain countries the tax authorities typically look at the comparable results from the year under consideration in assessing the position taken by the taxpayer rather than multiple-year averages.

Comment: While ASC 740-10 analyses are evaluated on an annual basis, the determination of risk depends on the regulations and guidance around each specific transaction. Therefore, for transfer pricing transactions, if a three-year average return can be considered arm's length in a given jurisdiction for that year, the risk of the return on that transaction will similarly be determined on the three-year average return.

e. How to Interpret Effective Settlement for Transfer Pricing Positions —

Under ASC 740-10-25-10, a tax position is considered effectively settled when all of the following conditions have been satisfied:

• The tax authority has completed its examination procedures including all appeals and administrative reviews that the tax authority is required and expected to perform for the tax position;

• The entity does not intend to appeal or litigate any aspect of the tax position included in the completed examination; and

• Based on the tax authority's widely understood policy, the entity considers it remote that the tax authority would subsequently examine or reexamine any aspect of the tax position included in the completed examination, presuming the tax authority has full knowledge of all relevant information.

Companies should evaluate whether their tax uncertainties meet the criteria specified above on a position-by-position basis.[103]

[103] ASC 740-10-25-9.

For transfer pricing-related UTPs, these same criteria apply, but with all of the interested parties involved, determining what "effective settlement" means for any given UTP can become complex. Generally, a company must consider the following specific factors that may influence whether an outcome is truly representative of effective settlement under the conditions of:

1. Taxpayer's willingness to agree to the position;

2. Position of the tax authority in the jurisdiction of the payor entity (jurisdiction #1) involved in the intercompany transaction; and

3. Position of the tax authority in the jurisdiction of the payee entity (jurisdiction #2) involved in the intercompany transaction.

If factors #1, 2 and 3, above, overlap (in that all would agree on a given price or range of prices), it may not be necessary to go any further to determine effective settlement. If factors #2 and #3 do not overlap, the following may also need to be considered:

1. Availability of MAP process in jurisdiction #1

2. Availability of MAP process in jurisdiction #2

3. The likelihood that management would pursue MAP;

a. whether management's historical appetite for such negotiations would indicate that it would pursue this alternative; and

b. whether it is likely to be pursued based on a cost/benefit analysis.

4. Expected negotiating positions of the relevant competent authorities

5. Expected outcome of MAP negotiations.

Comment: Before the case is effectively settled, it is important to ensure that all of the factors previously stated in ASC 740-10-25-10 are met.

(1) Considerations of Negotiations Between Taxpayer and Tax Authorities —

Within ASC 740-10, when there are offsetting adjustments, they may need to be disclosed separately.

(a) Rules About Netting Between Units of Account

(i) Netting Under a Transfer Pricing Audit —

When evaluating transfer pricing adjustments that may result from an audit, the focus is typically on adjustments that will result in an increase in taxable income. Potential transfer pricing adjustments that will result in a decrease in taxable income within the audited tax jurisdiction will not likely be proposed by the tax authorities but can be raised by the taxpayer in certain circumstances. These are referred to in the U.S. transfer pricing regulations as "setoffs."[104]

[104] See Reg. *§1.482.1(g)(4)* for a definition of setoffs and how they can be applied within an IRS transfer pricing audit.

For example, a taxpayer may utilize setoffs to challenge a potential or actual IRC §482 adjustment under examination. Setoffs may provide the taxpayer the right to offset an IRC §482 allocation between the same two taxpayers for the same taxable year by using another non-arm's length transaction (the setoff transaction). Reg. §1.482-1(g)(4)(ii) specifies that for a setoff to be applied, the taxpayer must satisfy the following procedural requirements: (i) establish that the setoff transaction was not arm's length and calculate the appropriate arm's length charge; (ii) document all correlative adjustments resulting from the setoff; and (iii) timely notify the IRS (within 30 days after the earlier of the NOPA or Statutory Notice of Deficiency).[105]

[105] *Taxpayer's Affirmative Use of IRC 482*, Internal Revenue Service, Document Control Number ISI/9422.09_03(2014) (updated Mar. 24, 2016).

(ii) Netting Under ASC 740-10 —

Notwithstanding the use of a setoff in an audit, each tax position must be evaluated under ASC 740-10 "without consideration of the possibility of offset or aggregation with other positions."[106] Because two tax jurisdictions are affected by an intercompany transaction, a resulting increase in taxable income in one jurisdiction is likely to result in double taxation, unless a MAP agreement is reached between the two tax jurisdictions. For purposes of applying ASC 740-10, each tax jurisdiction affected needs to be considered separately when assessing the sustainability of transfer pricing positions. This is discussed further below.

[106] ASC 740-10-25-7(c).

(2) Considerations of Negotiations Between Multiple Tax Authorities

(a) MAP Considerations —

When considering negotiations between multiple tax authorities, taxpayers may consider the use of MAP to calculate their tax position for their ASC 740-10 analysis.

Comment: There is uncertainty in establishing scenarios based on MAP outcomes since one cannot predict how the competent authorities will approach and resolve a specific matter. However, taxpayers can successfully use their best judgment, based upon precedents, the facts of their situation, and assumptions developed, to make a determination on how the competent authorities would resolve the matter.

Even with total relief from double taxation, a MAP outcome does not guarantee that there will be no change in total tax liability related to a transaction. If the audit involves a reallocation of income from a low-tax jurisdiction to a high-tax jurisdiction, the outcome from MAP could be that more income is recorded in the high-tax jurisdiction, while the low-tax entity records less. This outcome could have a material effect on the taxpayer's tax liability.

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E. How Many Scenarios Do You Need to Evaluate for Transfer Pricing Positions?

Scenarios need to be developed to illustrate the various outcomes that may result when analyzing the UTP under audit. While there is no rule to the number of scenarios that need to be developed, a company must develop enough scenarios to identify the one that has a cumulative probability of greater than 50 percent. A common practice is to also illustrate scenarios that go beyond 50 percent, as seen in ASC 740-10-55-103, which is illustrated in Worksheet 3. Having additional scenarios illustrated may help in a situation when an entity is debating the assigned probabilities with its auditors.

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F. Assigning Probabilities

ASC 740-10 provides guidance on how to perform the Measurement step through probabilities assigned to various expected outcomes (or scenarios) for a given Unit of Account. The scenarios, along with their assigned probabilities, are assembled in order of increasing tax benefit. The largest amount of tax benefit that has a cumulative probability of greater than 50 percent of being realized upon effective settlement is the one that is recognized in the financial statements.[107]

[107] *See* ASC 740-10-30-7, in addition to examples shown in paragraphs ASC 740-10-55-103 and 55-106.

Specifically, ASC 740-10-30-7 states, "[m]easurement of a tax position that meets the more-likely-than-not recognition threshold shall consider the amounts and probabilities of the outcomes that could be realized upon [effective] settlement using the facts, circumstances, and information available at the reporting date."[108] Examples 5 through 10 in ASC 740-10-55-99 through 55-116 illustrate the measurement rules. Although they do not contain required procedures, these illustrations form a source of specific guidance of how the Measurement analysis should be applied.

[108] ASC 740-10-30-7.

In some cases, one expected outcome will be clearly more probable than all other theoretically perceivable outcomes, and the determination of the recognizable tax benefit will be possible without substantial effort. This, however, is not generally the case in transfer pricing. Sometimes there is no outcome that is more probable than all other alternatives. In such cases, it may be appropriate to develop a table similar to the one presented in ASC 740-10-55-103, which is illustrated in Worksheet 3 .

Comment: Although the procedures for developing such tables and cumulative probability calculations may seem "scientific," there is a significant amount of subjectivity involved in this part of the analysis.

Generally, the assignment of probabilities is heavily dependent on the facts and circumstances of a particular transaction, management's experience and knowledge of the tax authority's position on the particular transaction, prior audit experience in the jurisdictions with respect to transfer pricing, and tax practitioners' expertise, for example.[109] Therefore, an evaluation of the qualitative aspects of a possible outcome will be important in justifying how one assigns probabilities. For example, one best practice is to document the rationale for why the output of the cumulative probability table makes sense (i.e., most accurately represents management's best estimate of what will occur under audit).

[109] Treasure, *FIN 48: Uncertain Tax Positions Associated With Transfer Pricing*, Mondaq Business Briefing (Aug. 22, 2007).

Assigning rounded percentages (i.e., rounded to the nearest 5 percent or 10 percent) as probabilities may be more effective than more specific numbers. In addition, auditors may be reluctant to accept the results of overly engineered econometric models with multiple assumptions, allocations, and technical adjustments. Simplicity and sound reasoning are likely to fare better with auditors.

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The overriding objective of the Recognition and Measurement requirements of ASC 740-10 is to clarify the accounting for uncertainty in income taxes recognized in a company's financial statements, thereby creating increased comparability and reliability in financial reporting. The financial statement disclosure requirements of ASC 740-10, therefore, seek to provide even more information about the uncertainty in income tax positions, including those related to transfer pricing, and include:[110]

[110] ASC 740-10-50-1 through ASC 740-10-50-23.

1. Recognition of interest and penalties related to an underpayment of income tax, as well as disclosure of the company's policy for classifying interest and penalties in accordance with the alternatives permitted in paragraph 740-10-45-25 in the notes to the financial statements.

2. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period.[111]

[111] ASC 740-10-50-15A. Additional guidance related to ASC 740-10-50-15A is anticipated to be effective on December 16, 2025, and makes slight modifications to specify that ASC 740-10-50-15A applies to "a public business entity" in place of "public entities." Expected changes have also been made to Example 30 (contained in ASC 740-10-55-217), which illustrates disclosures around uncertainty in income taxes.

3. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.[112]

[112] On December 14, 2023, FASB issued Accounting Standards Update *(ASU) No. 2023-09*, "Income Taxes (Topic 740): Improvements to Income Tax Disclosures. This update requires public business entities (PBEs, which replaces the previously used term of "public entities") to disclose additional information in specified categories related to the reconciliation of the effective tax rate to the statutory rate (i.e., rate reconciliation). BDO Bulletin, *FASB Issues Final ASU to Improve Income Tax Disclosures*, December 2023 provides additional details behind these updates, as well as the categories that must now be included in annual disclosures in the tabular reconciliation. Further, the requirement to disclose positions for which it is possible that the total amount of unrecognized tax benefits will significantly change within the next 12 months has been removed. This guidance will be effective for fiscal years beginning after December 15, 2024 and for interim periods for fiscal years beginning after December 15, 2025 for PBEs and for fiscal years beginning after December 15, 2025 and for interim periods beginning with fiscal years after December 15, 2026 for all other entities.

4. The total amounts of interest and penalties recognized in (a) the statement of operations, and (b) the statement of financial position.

5. The amount of income tax expense (or benefit) allocated to continuing operations and the amounts separately allocated to other items.[113]

[113] The addition of ASC 740-10-50-10A and ASC 740-10-50-10B content is also included in *ASU 2023-09*, which requires that income (or loss) from continuing operations before income tax expense (or benefit) be disaggregated between domestic and foreign operations. The disaggregation of income tax expense or benefit from continuing operations between federal, state, and foreign is also required annually.

6. Information related to positions for which it is possible that the total amounts of unrecognized tax benefits will significantly change within 12 months of the reporting date, including:

a. The nature of the uncertainty.

b. The nature of the event that could occur in the next 12 months that would precipitate the change.

c. An estimate of the range of the possible change or a statement explaining that an estimate cannot be made.

7. A description of taxable years that remain subject to examination by major tax jurisdictions.

Certain provisions, such as those related to interest and penalties, tabular reconciliations, and unrecognized tax benefits, have particular relevance for transfer pricing. Information about transfer pricing disputes with tax authorities, litigation, and settlements are typically found in the disclosures and can lend insight to taxpayers and practitioners into potential audit issues. Each such provision will be discussed in further detail in the sections below, with the use of examples to highlight that provision's specific application to transfer pricing.

Comment: While *ASC-740-50* provides high-level guidance on categories of income tax information that should be disclosed in a company's financial statements, this guidance is not intended to be comprehensive or inclusive of all appropriate disclosures.

A. Interest and Penalties

In the event of an underpayment of tax, ASC 740-10 requires that any applicable interest payments that may be imposed by the relevant tax authority be recognized in the first period the interest would begin accruing. The amount of interest expense to be accrued is calculated by applying the relevant statutory interest rate to the difference between the tax position that was taken on the tax return and the ASC 740-10 amount.[114] Similarly, if the resultant underpayment of tax under the MLTN standard of ASC 740-10 would be subject to a penalty in the relevant jurisdiction, the penalty is recognized in the period in which it is determined. If penalties were not recognized when the position was initially taken, recognition is to occur when the company's judgment changes.[115] In other words, if in Year 2 a company's management believes that a position previously reported in Year 1 would be subject to penalties, associated penalties are to be recognized in Year 2.

[114] ASC 740-10-25-56.

[115] ASC 740-10-25-57.

Under ASC 740-10 a tax liability is created for an underpayment of tax since it represents a potential future obligation to the tax authority. The resultant underpayment of tax (i.e., the difference between a tax position under the MLTN standards of ASC 740-10 and the position on the tax return) is classified as a current liability if payment of the tax deficiency is expected to occur within one year (or within one business cycle, if longer than one year), rather than a deferred tax liability. Any applicable interest recognized because of the tax underpayment may be classified in the financial statements as either part of income tax expense or interest expense, based on the company's accounting election. Any applicable penalties recognized may be classified as either income taxes or another pre-tax expense classification. Disclosure of the interest and penalty classification policy must be provided in the footnotes of the financial statements.[116] Classifications of interest and penalties must be applied consistently. In the event of a change in classification, a public entity must file a preferability letter with the SEC under Item 601(b)(18) of Regulation S-K for public companies from its independent accountant concurring with its conclusion as to the new method's preferability when the change is made.[117]

[116] ASC 740-10-50-19.

[117] ASC 250, A S 2820, S-X 10-01.

Comment: Assessment of transfer pricing penalties and interest are becoming more common, even in cases where contemporaneous documentation is provided for the transfer pricing position in question. For example, the IRS is asserting penalties in a number of recent, high-profile cases (e.g., Amgen with $10.7 billion of tax, penalties and interest and Microsoft with $28.9 billion of taxes, plus penalties and interest).[118] Therefore, a company should reconsider its assessment of whether interest and penalties may be assessed in keeping with the current environment, along with the amount of potential interest and penalties to include in the calculation of any transfer-pricing-related uncertain tax positions.

[118] Steven C. Wrappe and April D. Little, *Transfer Pricing Uncertain Tax Positions: Learning the New Math*, Bloomberg Law News 2023-11-28T15:07:04000-05:00.

Example 1: In tax year 2022, a U.S. Parent (USP) provides its patented technological know-how to its newly formed Foreign Subsidiary (Sub) for use in the manufacture and sale of product to local customers and other foreign affiliates. USP did not charge a royalty for the use of this know-how by the Sub. In tax year 2023 (the current taxable year), while conducting an ASC 740-10 analysis, USP's management concludes that an arm's length royalty in the amount of 5 percent of sales should have been charged to Sub during 2021. During 2021, Sub's sales totaled $20 million. Assuming USP's U.S. tax rate is 21 percent, the underpayment of tax (or the tax position under ASC 740-10) is $210,000 ($20,000,000 of Sub sales × 5% royalty × 21% tax rate). The resultant underpayment of tax is subject to a 40 percent transactional penalty under the U.S. regime;[119] that is, a gross valuation transactional penalty is automatically triggered since USP failed to impose a transfer price when one was justified. Therefore, in 2023, USP recognizes $84,000 in penalty expense. In addition, USP's management estimates that interest would be 5 percent, and therefore recognizes $10,500 in interest. USP classifies accrued interest and penalties as income tax expense, and in 2023 records a current tax liability of $210,000 for the tax deficiency and income tax expense of $94,500 for the applicable penalties and interest. A footnote in USP's financial statements for 2023 contains the following disclosure: “The Company recognizes accrued interest and penalties related to unrecognized tax benefits in income tax expense. The amount of interest and penalties recorded as income tax expense during the taxable year 2023 was $10,500 and $84,000, respectively” (assuming no MAP relief).

[119] *See* Reg. §1.6662-6(b)(2).

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B. Tabular Reconciliations

ASC 740-10 requires a tabular reconciliation of the total amounts of unrecognized tax benefits, excluding interest and penalties, at the beginning and end of the period. This should include, at minimum:[120]

[120] ASC 740-10-50-15A.

a. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.

b. The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.

c. Any decreases in unrecognized tax benefits relating to settlements with tax authorities. The difference between the

ASC 740-10 liability and the settlement should be included in the gross amounts of increases/decreases in unrecognized tax benefits as a result of tax positions taken during a prior period (*see* a. above).

d. Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

A Public Business Entity (PBE) is also required to disclose the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

In response to investor requests for more transparency around income tax disclosures, particularly with respect to rate reconciliation and income taxes paid, FASB issued Accounting Standards Update *(ASU) No. 2023-09*, “Income Taxes (Topic 740): Improvements to Income Tax Disclosures in December 2023. This update requires PBEs to disclose on an annual basis a tabular reconciliation, using both percentages and reporting currency amounts, pertaining to the following specific categories:[121]

[121] ASC 740-10-50-12A.

1. State and local income tax, net of federal (national) income tax effect;

2. Foreign tax effects;

3. Effect of changes in tax laws or rates enacted in the current period;

4. Effect of cross-border tax laws;

5. Tax credits;

6. Changes in valuation allowances;

7. Nontaxable or non-deductible items; and

8. Changes in unrecognized tax benefits.

A company's transfer pricing can have an impact on each of the categories specified above. Reconciling items 1–7 above are required to be presented on a gross basis with the following exception: unrecognized tax benefits and the related tax positions, as well as tax effects of certain cross-border tax laws and the related tax credits, may be presented on a net basis. Furthermore, for item 8 above, reconciling items presented in this category may be disclosed on an aggregated basis for all jurisdictions.

Example 2: Returning to Example 1 in VII.A.1, in addition to the prior period underpayment of tax of $210,000 resulting from the license of patented technological know-how from USP to Sub for use in the manufacture and sale of product, USP believes Sub may have undercharged another foreign related affiliate (FA) for manufactured product during the current taxable year (2023). Specifically, Sub charged FA a transfer price of resale minus 50 percent, while Sub charged a third-party resale minus 25 percent for identical products sold into the same market. For example, assuming a resale price of $100, the price charged to FA would be $50 and the arm's length transfer price based on third-party comparable transactions would be $75. Further, assume Sub sold 100,000 units to FA during 2023, and Sub's tax rate is 25 percent, the resultant underpayment of tax is $625,000 ($75 – $50 × 100,000 × 0.25). Therefore, in 2023 Sub reflects this $625,000 potential underpayment in its tabular reconciliation under the line entitled “addition based on tax positions related to the current year.” (For ease of simplicity, it is assumed that the potential underpayment of tax does not give rise to either interest or penalties in the tax jurisdiction of Sub.)

Incidentally, USP had also recorded an ASC 740-10 liability in 2020 related to a potential underpayment of tax for purchases from a related-party manufacturer (MFG) in Country X to FA during the 2019 taxable year. In this case, MFG also charged FA a transfer price of resale minus 50 percent, but charged a third-party resale minus 30 percent for identical products sold into the same market. Assuming: (1) a resale price of $100; (2) 100,000 units were sold by MFG to FA during 2006; and (3) MFG's tax rate is 30 percent, the resultant ASC 740-10 liability was recorded at $600,000 during 2020 ($70 – 50 × 100,000 × 0.30).

Additionally, in the current year (2023) USP settled a transfer pricing dispute with the IRS related to the provision of corporate services in the amount of $1 million. USP had previously recorded an ASC 740-10 liability of $1.5 million related to this dispute. USP, therefore, includes a reduction of $1 million in its tabular reconciliation for settlements, and a reduction of $500,000 for a prior year tax position. Finally, the statute of limitations in Country X is three years, and thus the ASC 740-10 liability of $600,000 recorded in 2020 has lapsed and can be removed from the tabular reconciliation as it is a reduction due to lapse of applicable statute of limitations.

Assuming the opening balance of unrecognized tax benefit for the current taxable year was $2 million, the resultant tabular reconciliation for USP's uncertain positions related to transfer pricing is as follows:

Unrecognized Tax Benefit Reconciliation	
	Unrecognized Tax Benefit (in 000s) Current Tax Year (2023)
Balance at January 1	$2,000.0
Additions based on tax positions related to the current year	$625.0
Additions for tax positions of prior years	$210.0
Reductions for tax positions of prior years	($500.0)
Settlements	($1,000.0)
Reductions due to lapse of applicable statute of limitations	($600.0)
Balance at December 31	$735.0

Country-specific disclosures are required in a tabular reconciliation if the 5.0 percent threshold under paragraph 740-10-50-12A(b)(2) is met. The 5.0 percent threshold is computed by multiplying the income (or loss) from continuing operations before income taxes by the applicable statutory federal (national) income tax rate of the United States. Consider Case A presented in ASC 740-10-55-231. The foreign tax effects in this example may be directly impacted by transfer pricing as shown in Example 3 below.

Example 3: [122] The entity is domiciled in the United States and presents comparative financial statements. For the disclosure of foreign tax effects in accordance with paragraph 740-10-50-12A(b)(2), it is assumed that the 5.0 percent threshold is met for:

[122] ASC 740-10-55-231. For PBEs, this guidance is effective for fiscal years beginning after December 15, 2024, and for interim periods for fiscal years beginning after December 15, 2025. For all other entities, it is effective for fiscal years beginning after December 15, 2025, and for interim periods beginning with fiscal years after December 15, 2026, for all other entities.

1. Ireland, both at the jurisdiction level and for certain individual reconciling items of the same nature within Ireland;

2. The United Kingdom, for certain individual reconciling items of the same nature within the United Kingdom, but not at the jurisdictional level; and

3. Switzerland and Mexico, at the jurisdiction level, but not for any individual reconciling items of the same nature within each jurisdiction.

The country-specific disclosures within the tabular reconciliation may be presented similarly to the following illustration reproduced from Case A in ASC 740-10-55-231:

	Year Ended December 31, 20X2		Year Ended December 31, 20X1		Year Ended December 31, 20X0	
	Amount	Percent	Amount	Percent	Amount	Percent
U.S. Federal Statutory Tax Rate	$ AA	aa %	$ BB	bb %	$ CC	cc %
State and Local Income Taxes, Net of Federal Income Tax Effect [(a)]	AA	aa	BB	bb	CC	cc
Foreign Tax Effects						
United Kingdom						
Statutory tax rate difference between United Kingdom and United States	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Share-based payment awards	AA	aa	BB	bb	CC	cc
Research and development tax credits	(AA)	(aa)	(BB)	(bb)	CC	cc
Other	(AA)	(aa)	BB	bb	(CC)	(cc)
Ireland						
Statutory tax rate difference between Ireland and United States	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Changes in valuation allowances	(AA)	(aa)	(BB)	(bb)	CC	cc
Enacted changes in tax laws or rates	-	-	BB	bb	-	-
Other	AA	aa	(BB)	(bb)	(CC)	(cc)
Switzerland	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Mexico	AA	aa	BB	bb	CC	cc
Other foreign jurisdictions	(AA)	(aa)	(BB)	(bb)	CC	cc
Effect of Changes in Tax Laws or Rates Enacted in the Current Period	-	-	-	-	(CC)	(cc)
Effect of Cross-Border Tax Laws						
Global intangible low-taxed income	AA	aa	BB	bb	CC	cc
Foreign-derived intangible income	(AA)	(aa)	(BB)	(bb)	(CC)	(cc)
Base erosion and anti-abuse tax	AA	aa	BB	bb	CC	cc
Other	AA	aa	-	-	-	-
Tax Credits						
Research and development tax credits	-	-	(BB)	(bb)	(CC)	(cc)
Energy-related tax credits	(AA)	(aa)	-	-	-	-
Other	-	-	(BB)	(bb)	-	-
Changes in Valuation Allowances	AA	aa	(BB)	(bb)	(CC)	(cc)
Nontaxable or Nondeductible Items						
Share-based payment awards	AA	aa	BB	bb	CC	cc
Goodwill impairment	AA	aa	BB	bb	-	-
Other	AA	aa	(BB)	(bb)	CC	cc
Changes in Unrecognized Tax Benefits	(AA)	(aa)	BB	bb	(CC)	(cc)
Other Adjustments	AA	aa	(BB)	(bb)	(CC)	(cc)
Effective Tax Rate	$ AA	aa %	$ BB	bb %	$ CC	cc %

[(a)] State taxes in California and New York made up the majority (greater than 50 percent) of the tax effect in this category.

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C. Quarterly and Annual Disclosures

ASC 740-10-50-15 provides that the required disclosures be presented following the end of each annual reporting period (i.e., in a Form 10-K for U.S. public companies). Therefore, tabular reconciliations are only required to be provided in annual filings, although any material changes related to other disclosure requirements must be provided in interim periods.

D. "Early Warning" Disclosures

Transfer pricing assessments, as well as disputes between multinational taxpayers and tax authorities, are often revealed in interim filings. An example of how companies are reporting uncertainties for transfer pricing positions is provided below.

In its SEC Form 10-Q filing for the quarterly period ended September 29, 2023, Coca-Cola included the following interim disclosure concerning transfer pricing:[123]

[123] The Coca-Cola Company SEC Form 10-Q filing for the quarterly period ended September 29, 2023. https://www.sec.gov/ix?doc=/Archives/edgar/data/0000021344/000002134423000060/ko-20230929.htm.

> The Company is involved in various tax matters, with respect to some of which the outcome is uncertain. These uncertain tax matters may result in the assessment of additional taxes.
>
> On September 17, 2015, the Company received a Statutory Notice of Deficiency (Notice) from the U.S. Internal Revenue Service (IRS) seeking approximately $3.3 billion of additional federal income tax for years 2007 through 2009. In the Notice, the IRS stated its intent to reallocate over $9 billion of income to the U.S. parent company from certain of its foreign affiliates that the U.S. parent company licensed to manufacture, distribute, sell, market and promote its products in certain non-U.S. markets.
>
> The Notice concerned the Company's transfer pricing between its U.S. parent company and certain of its foreign affiliates. IRS rules governing transfer pricing require arm's length pricing of transactions between related parties such as the Company's U.S. parent and its foreign affiliates …
>
> … In determining the amount of tax reserve to be recorded as of December 31, 2020, the Company completed the required two-step evaluation process prescribed by Accounting Standards Codification 740, Accounting for Income Taxes. In doing so, we consulted with outside advisors, and we reviewed and considered relevant laws, rules, and regulations, including, but not limited to, the Opinion and relevant caselaw. We also considered our intention to vigorously defend our positions and assert our various well-founded legal claims via every available avenue of appeal. We concluded, based on the technical and legal merits of the Company's tax positions, that it is more likely than not the Company's tax positions will ultimately be sustained on appeal. In addition, we considered a number of alternative transfer pricing methodologies, including the methodology asserted by the IRS and affirmed in the Opinion (Tax Court Methodology), that could be applied by the courts upon final resolution of the litigation. Based on the required probability analysis, we determined the methodologies we believe the federal courts could ultimately order to be used in calculating the Company's tax. As a result of this analysis, we recorded a tax reserve of $438 million during the year ended December 31, 2020 related to the application of the resulting methodologies as well as the different tax treatment applicable to dividends originally paid to the U.S. parent company by its foreign licensees, in reliance upon the Closing Agreement, that would be recharacterized as royalties in accordance with the Opinion and the Company's analysis.

> 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 September 29, 2023. 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 September 29, 2023, to $432 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, which could have a material adverse impact on the Company's financial position, results of operations and cash flows.
>
> The Company calculated the potential impact of applying the Tax Court Methodology to reallocate income from foreign licensees potentially covered within the scope of the Opinion, assuming such methodology were to be ultimately upheld by the courts and the IRS were to decide to apply that methodology to subsequent years with consent of the federal courts. This impact would include taxes and interest accrued through December 31, 2022 for the 2007 through 2009 litigated tax years and for subsequent tax years from 2010 through 2022. The calculations incorporated the estimated impact of correlative adjustments to the previously accrued transition tax payable under the 2017 Tax Cuts and Jobs Act. The Company estimates that the potential aggregate incremental tax and interest liability could be approximately $14 billion as of December 31, 2022. Additional income tax and interest would continue to accrue until the time any such potential liability, or portion thereof, were to be paid. The Company estimates the impact of the continued application of the Tax Court Methodology for the three and nine months ended September 29, 2023, would increase the potential aggregate incremental tax and interest liability by approximately $400 million and $1,200 million, respectively. Additionally, we currently project the continued application of the Tax Court Methodology in future years, assuming similar facts and circumstances as of December 31, 2022, would result in an incremental annual tax liability that would increase the Company's effective tax rate by approximately 3.5%.
>
> The Company does not know when the Tax Court will issue its opinion regarding the effect of Brazilian legal restrictions on the payment of royalties by the Company's licensee in Brazil for the 2007 through 2009 tax years. After the Tax Court issues its opinion on the Company's Brazilian licensee, the Company and the IRS will be provided time to agree on the tax impact of both opinions, after which the Tax Court would render a decision in the case. The Company will have 90 days thereafter to file a notice of appeal to the U.S. Court of Appeals for the Eleventh Circuit and pay the tax liability and interest related to the 2007 through 2009 tax years. The Company currently estimates that the payment to be made at that time related to the 2007 through 2009 tax years, which is included in the above estimate of the potential aggregate incremental tax and interest liability, would be approximately $5.6 billion (including interest accrued through September 29, 2023), plus any additional interest accrued through the time of payment. Some or all of this amount would be refunded if the Company were to prevail on appeal.

Interim disclosures may provide an "early warning" to investors or others who rely on information contained in filings as to a company's financial health. As the disclosure above suggests, transfer pricing issues could have a material adverse effect on a company's operational results and financial condition.

E. Effect of Court Decisions

In addition to an entity's own transfer pricing-related positions and litigation, a court decision involving an unrelated taxpayer with a similar transfer pricing issue could affect the entity's ASC 740-10 calculations and disclosures.

The *Altera* litigation provides an interesting example. In 2003, the IRS and Treasury Department issued revised transfer pricing regulations that (in part) required the inclusion of stock-based compensation in the calculation of intangible development costs in a cost sharing arrangement (CSA). Based on these revised regulations, the IRS audited Altera Corporation for 2004 through 2007 and proposed an adjustment to include the value of stock-based compensation in Altera's CSA. Altera challenged the IRS adjustment and in 2015, the Tax Court ruled in favor of Altera.[124] The IRS appealed the Tax Court decision, and ultimately the Ninth Circuit reversed the Tax Court and ruled in favor of the IRS.[125]

[124] *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015).

[125] *Altera Corp. v. Commissioner,* 926 F.3d 1061 (9th Cir. 2019).

Altera appealed the Ninth Circuit decision to the Supreme Court, but the request was denied and the Ninth Circuit decision stands. In the Ninth Circuit there is little disagreement that stock-based compensation should be included in CSAs. However, outside of the Ninth Circuit, the Tax Court decision (in favor of Altera) stands. This situation raises the question of whether a taxpayer outside the Ninth Circuit can recognize the benefit of not including stock-based compensation in its CSA. Companies outside the Ninth Circuit can rely on the Tax Court decision but must also consider the Supreme Court's decision not to hear the Altera appeal and the likelihood that another Circuit Court would rule in a similar case in the same way as the Ninth Circuit in Altera.

Comment: Following *Altera*, companies must be careful when making ASC 740-10 determinations and disclosure decisions based upon court decisions. Circuit Court decisions that are in conflict with Tax Court decisions require an analysis of the likelihood that other Circuits would rule one way or the other. And while a case is still being appealed, reliance on a lower court ruling could result in a company needing to revise its prior calculations and/or reverse its prior disclosures. Given the impact that court cases and their outcomes can have on ASC-740 calculations and disclosures, it is important to stay up-to-date on significant transfer pricing cases and outcomes.

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F. Compliance Considerations

While it was not FASB's intent to overly burden financial statement issuers in complying with ASC 740-10 disclosure requirements, companies continue to face challenges in disclosing tax positions. This is particularly the case with respect to transfer pricing as there can often be a great deal of subjectivity surrounding assessments and disputes, and the timing of negotiations and ultimate resolution is highly unpredictable. Companies may have difficulty in determining the types of information and amount of detail required to be included in financial statement footnotes regarding significant changes to unrecognized tax benefits over the next 12 months, in particular. Companies have also come to realize that ongoing disclosure compliance has involved as much effort as was expended during initial adoption of ASC 740-10. And of particular relevance to transfer pricing, internal tax resources within multinational corporations must obtain the necessary information from foreign affiliates in a timely manner to analyze local issues and prepare any related disclosures, which can impose an additional challenge.

Comment: Although there is no formal guidance within ASC-740 for the required level and extent of transfer pricing documentation as it relates to mandatory disclosures, a company should be able, as a starting point, to affirm the following:

1. Recognition: The company is comfortable that it has identified and quantified the exposures related to transfer pricing. This level of comfort requires that the company is aware and is tracking all intercompany transactions taking place. To properly account for intercompany transactions, the company must understand which tax years are open, what transfer pricing audits have occurred, and what documentation exists to support the nature of the company's intercompany pricing.

2. Measurement: The company has calculated the amounts that are reported on tax returns, which will constitute the actual UTPs that ASC 740-10 analyses are supposed to evaluate. Sections II–V detail the processes associated with these calculations for transfer pricing positions.

For additional details on transfer pricing documentation and the arm's length standard, please refer to Section III.B.1.

G. Schedule UTP

Schedule UTP of Form 1120 is a U.S. tax form that requires certain U.S. taxpayers[126] to provide information about tax positions that affect the U.S. federal income tax liabilities. Companies required to file a Schedule UTP include public or privately held corporations that:

[126] Corporations filing Forms 1120, 1120-F, 1120-L, or 1120-PC must file Schedule UTP if total assets equal or exceed USD $10 million for the tax year and the corporation recorded a liability for unrecognized tax benefits for a tax position in audited financial statements.

- issue or are included in audited financial statements;
- file a Form 1120, 1120-F, 1120-L or 1120-PC;
- have assets that equal or exceed $100 million; and
- have one or more reportable tax positions.

The form generally must be included with a company's income tax return for each tax year.

A company must report on Schedule UTP each U.S. income tax position for which two conditions are satisfied:

1. The company has taken a tax position on its U.S. federal income tax return for the current tax year or for a prior tax year; and

2. Either the company or a related party has recorded a liability for unrecognized tax benefits with respect to that tax position for U.S. federal income tax in audited financial statements *or* the company or related party recognized the tax

benefit with no reserve for that tax position because the company expects to litigate that position.

If the company evaluates a tax position and determines that it meets the recognition threshold for uncertain tax benefits in an interim audited financial statement issued before the tax position is taken on a return, the corporation need not report the tax position to which the tax benefits relates on Schedule UTP.

To complete the Schedule UTP, a company must use the same Unit of Account as in audited financial statements. It must rank each tax position by the amount of U.S. income tax reserve recorded for that position and include a concise description of each UTP. A company must also indicate whether a position is related to transfer pricing by placing a “T” next to the ranking of each position. For example, if a corporation has one transfer pricing tax position and it represents the largest position reported, the taxpayer would enter “T1” next to the associated transfer pricing position.

In addition, for tax years 2022 and later, five new columns were added to the Uncertain Tax Position Statement, including:[127]

[127] Schedule UTP (Form 1120), *available at* https://www.irs.gov/pub/irs-prior/f1120utp--2022.pdf. Retrieved July 1, 2024.

1. Rev. Rul., Rev. Proc., etc.
2. Regulation Section and Regulation Subsection
3. Form or Schedule
4. Line No.
5. Amount

Number 1 and Number 2 above are used when Schedule UTP is filed instead of Form 8275 (Disclosure Statement) and Form 8275-R (Regulation Disclosure Statement). Numbers 3 through 5 above are used to identify the location on the tax return where the uncertain tax position is reported.[128] Additional guidance on reporting uncertain tax positions on Schedule UTP may be found on the IRS.gov website.[129]

[128] Schedule UTP Instructions, *available at* https://www.irs.gov/pub/irs-pdf/i1120utp.pdf. Retrieved July 1, 2024.

[129] https://www.irs.gov/businesses/corporations/uncertain-tax-positions-schedule-utp#guidance.

The effect of Schedule UTP for taxpayers is that they are required to provide information about their reserves directly to the IRS. The fact that transfer pricing positions are specifically highlighted in the schedule indicates that these positions will be given distinct attention in IRS exams. Strategies to reduce the number of items that appear on a company's Schedule UTP will generally be similar to those used to reduce a company's ASC 740-10 reserves related to U.S. tax positions.

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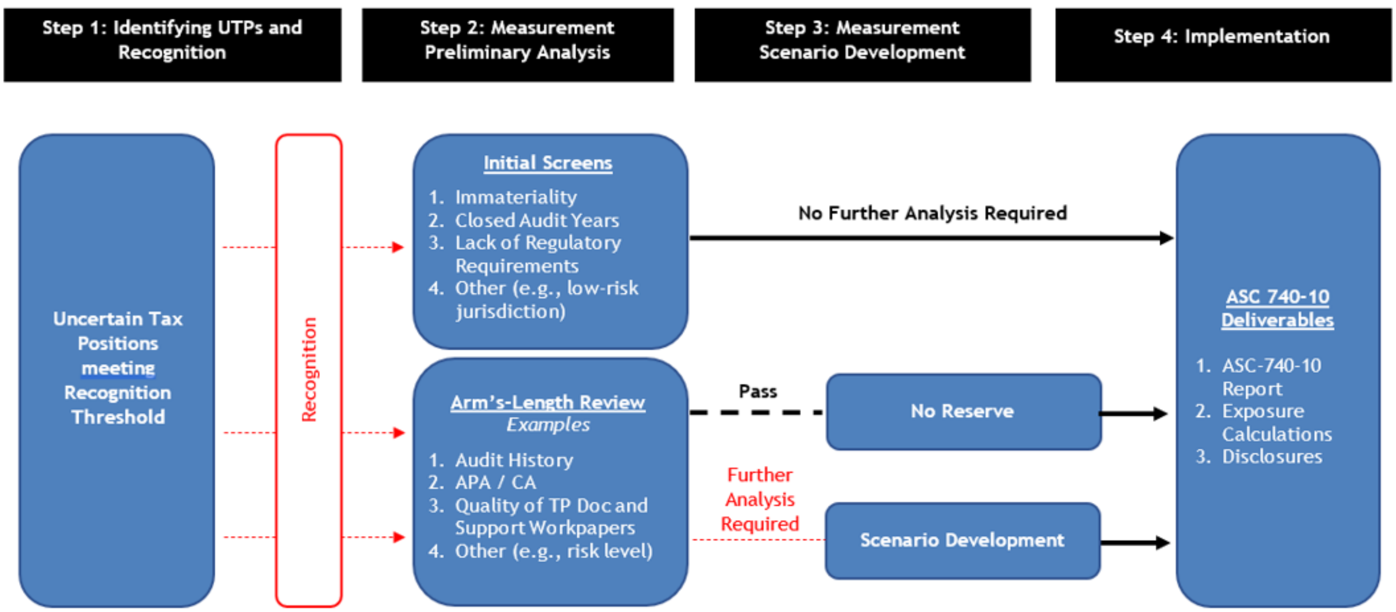
Table of Worksheets

Worksheet 1 Sample ASC 740-10 Process Overview



Worksheet 2 Case Study

The purpose of this case study is to illustrate the process for identifying transfer pricing transactions that must be measured under ASC 740-10-30.

Fact Pattern: U.S. HQ, Inc. is a U.S. company with its world headquarters in Atlanta, GA. U.S. HQ, Inc. is in the business of developing and manufacturing computers and software that are sold with its proprietary products. It owns all the proprietary trademarks, trade names and other intangible assets related to its business. Along with being the group's global headquarter, U.S. HQ, Inc. also has subsidiaries all over the world that assist in the manufacturing, distribution, and certain other services performed in operating a global business. U.S. HQ, Inc. is considered the non-routine or entrepreneurial entity within the affiliated group's value chain.

Exhibit 1, below, contains the legal names, locations, key functions, and intercompany activities of each affiliated entity.[1]

[1] The fact pattern and exhibits provided in Worksheet 2 are meant for illustrative purposes only and should not be used for any other purposes (e.g., advice).

EXHIBIT 1 — Summary of U.S. HQ, Inc.'s Global Operations

Legal Entity	Location	Key Functions	Intercompany Activities
US HQ, Inc.	US	HQ / Manufacturer / IP Owner	World headquarters and owner of all non-routine intangible assets of the global group. US HQ, Inc. is responsible for the development, enhancement, maintenance, protection, and (rights to) exploitation of the group's IP. It also manufactures and sells products. In addition, US HQ, Inc. is responsible for the intercompany financing (e.g., provides loans and guarantees) to certain related affiliates.
UK Ltd.	UK	Manufacturer / Distributor	Performs both manufacturing and distribution activities related to computer and software products.
UK HQ, Ltd.	UK	Regional HQ	Operates as the regional HQ for EMEA and provides management services to related affiliates in its region.
Dutch Co.	Netherlands	Distributor	Purchases products from US HQ, Inc. and UK Ltd. and distributes these products to third-party customers in the Netherlands and surrounding regions.
Canada Ltd.	Canada	Distributor	Purchases products from US HQ, Inc. and UK Ltd. and distributes these products to third-party customers in Canada.
Brazil Ltda.	Brazil	Distributor	Purchases products from US HQ, Inc. and UK Ltd. and distributes these products to third-party customers in Brazil and other locations in South America.
HK Ltd.	China	Distributor / Service Provider	Purchases products from US HQ, Inc. and UK Ltd. and distributes these products in China and other locations within the Asia Pacific region. HK Ltd. also performed contract research & development services on behalf of US HQ, Inc. before the establishment of

			India Pvt. Ltd.
USA, Inc.	US	Distributor	Purchases products from US HQ, Inc. and UK Ltd. and distributes these products within certain regions in the US.
India Pvt. Ltd.	India	Service Provider	Performs contract research & development services on behalf of US HQ, Inc.

In preparing for its ASC 740-10 analysis, management of U.S. HQ, Inc. (in coordination with their auditors) set materiality thresholds to apply in preparing the ASC 740-10 transfer pricing analysis. For this case study, the Auditor agreed to the following materiality thresholds under which management would examine all intercompany tangible good transactions that meet the criteria below:

• Involve U.S. HQ, Inc. with a cumulative transaction volume of greater than U.S. $5,000,000 over a six-year period; or,

• Involve entities outside the U.S. with a cumulative transaction volume of greater than U.S. $1,000,000 for a six-year period.

Due to the nature of the transaction, no materiality thresholds were placed on intercompany transactions involving intangible property transfers or provision of services. These materiality thresholds were established based upon many factors including that these thresholds are used in other analyses (*e.g.*, Sarbanes 404) for U.S. HQ, Inc. and the company believes will accurately reflect all of the major intercompany transactions the company has on a worldwide basis.

When conducting the ASC 740-10 transfer pricing analysis, management of U.S. HQ, Inc. retrieved financial data for all of the company's intercompany transactions covering the last six years. This data was broken out by transaction type as follows: tangible (Exhibit 2), intangibles (Exhibit 3), services (Exhibit 4), and loans and guarantees (Exhibit 5).

Once the intercompany transactions were identified, the company established criteria used to perform a preliminary analysis to identify transactions that may result in UTPs. The criteria applied to the transactions was discussed with and agreed upon by the company's auditors before conducting the preliminary testing. This Preliminary Testing matrix is provided in Exhibit 6.

#	Transaction Type	Financial Reporting Period	Transaction Amount (USD$)	Provider of Service / Licensor	Jurisdiction of Provider / Licensor	Receiver of Service / Licensee	Jurisdiction of Receiver / Licensee	Open Year (Provider / Licensor)	Open Year (Receiver / Licensee)	Exceeds Threshold	Intra-Country Transaction
1	Tangible Property Sales	12/31/2023	8,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No
2	Tangible Property Sales	12/31/2022	7,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No
3	Tangible Property Sales	12/31/2021	5,500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No
4	Tangible Property Sales	12/31/2020	5,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No
5	Tangible Property Sales	12/31/2019	3,000,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	No	No
6	Tangible Property Sales	12/31/2018	2,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	No	No
7	Tangible Property Sales	12/31/2023	2,000,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	No	No
8	Tangible Property Sales	12/31/2022	1,500,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	No	No
9	Tangible Property Sales	12/31/2021	1,000,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	No	No
10	Tangible Property Sales	12/31/2023	4,000,000	UK Ltd.	UK	Dutch Co.	Netherlands	Open	Open	Yes	No
11	Tangible Property Sales	12/31/2022	3,000,000	UK Ltd.	UK	Dutch Co.	Netherlands	Open	Open	Yes	No
12	Tangible Property Sales	12/31/2021	2,000,000	UK Ltd.	UK	Dutch Co.	Netherlands	Open	Open	Yes	No
13	Tangible Property Sales	12/31/2023	200,000	UK Ltd.	UK	HK Ltd.	China	Open	Open	No	No
14	Tangible Property Sales	12/31/2022	150,000	UK Ltd.	UK	HK Ltd.	China	Open	Open	No	No
15	Tangible Property Sales	12/31/2021	100,000	UK Ltd.	UK	HK Ltd.	China	Open	Open	No	No
16	Tangible Property Sales	12/31/2023	200,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	No	No
17	Tangible Property Sales	12/31/2022	150,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	No	No
18	Tangible Property Sales	12/31/2021	100,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	No	No

#	Transaction Type	Financial Reporting Period	Transaction Amount (USD$)	Provider of Service / Licensor	Jurisdiction of Provider / Licensor	Receiver of Service / Licensee	Jurisdiction of Receiver / Licensee	Open Year (Provider / Licensor)	Open Year (Receiver / Licensee)	Exceeds Threshold	Intra-Country Transaction
19	Intangible (Royalty)	12/31/2023	3,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
20	Intangible (Royalty)	12/31/2022	2,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
21	Intangible (Royalty)	12/31/2021	1,250,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
22	Intangible (Royalty)	12/31/2020	1,750,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
23	Intangible (Royalty)	12/31/2019	1,550,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	N/A	No
24	Intangible (Royalty)	12/31/2018	1,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	N/A	No
25	Intangible (Royalty)	12/31/2023	2,000,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No
26	Intangible (Royalty)	12/31/2022	1,500,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No
27	Intangible (Royalty)	12/31/2021	1,250,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No
28	Intangible (Royalty)	12/31/2023	5,000,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
29	Intangible (Royalty)	12/31/2022	3,000,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
30	Intangible (Royalty)	12/31/2021	2,000,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
31	Intangible (Royalty)	12/31/2023	0	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No
32	Intangible (Royalty)	12/31/2022	0	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No
33	Intangible (Royalty)	12/31/2021	0	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No
34	Intangible (Royalty)	12/31/2023	0	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No
35	Intangible (Royalty)	12/31/2022	0	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No
36	Intangible (Royalty)	12/31/2021	0	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No
37	Intangible (Royalty)	12/31/2023	5,000,000	US HQ, Inc.	US	USA Inc.	US	Open	Open	N/A	Yes
38	Intangible (Royalty)	12/31/2022	3,000,000	US HQ, Inc.	US	USA Inc.	US	Open	Open	N/A	Yes
39	Intangible (Royalty)	12/31/2021	2,000,000	US HQ, Inc.	US	USA Inc.	US	Open	Open	N/A	Yes

#	Transaction Type	Financial Reporting Period	Transaction Amount (USD$)	Provider of Service / Licensor	Jurisdiction of Provider / Licensor	Receiver of Service / Licensee	Jurisdiction of Receiver / Licensee	Open Year (Provider / Licensor)	Open Year (Receiver / Licensee)	Exceeds Threshold	Intra-Country Transaction
40	Management Service	12/31/2023	800,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
41	Management Service	12/31/2022	750,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
42	Management Service	12/31/2021	500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
43	Management Service	12/31/2020	500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
44	Management Service	12/31/2019	500,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	N/A	No
45	Management Service	12/31/2018	500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	N/A	No
46	Management Service	12/31/2023	100,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No
47	Management Service	12/31/2022	100,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No
48	Management Service	12/31/2021	100,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No
49	Management Service	12/31/2023	50,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
50	Management Service	12/31/2022	50,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
51	Management Service	12/31/2021	50,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
52	Management Service	12/31/2023	50,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No
53	Management Service	12/31/2022	50,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No
54	Management Service	12/31/2021	50,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No
55	Management Service	12/31/2023	50,000	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No
56	Management Service	12/31/2022	50,000	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No
57	Management Service	12/31/2021	50,000	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No
58	Management Service	12/31/2023	25,000	UK HQ, Ltd.	UK	UK Ltd.	UK	Open	Open	N/A	Yes
59	Management Service	12/31/2022	25,000	UK HQ, Ltd.	UK	Dutch Co.	Netherlands	Open	Open	N/A	No
60	R&D Service	12/31/2023	2,200,000	India Pvt Ltd.	India	US HQ, Inc.	US	Open	Open	N/A	No
61	R&D Service	12/31/2022	2,000,000	India Pvt Ltd.	India	US HQ, Inc.	US	Open	Open	N/A	No
62	R&D Service	12/31/2021	1,750,000	HK Ltd.	China	US HQ, Inc.	US	Open	Open	N/A	No
63	Marketing Service	12/31/2023	0	UK Ltd.	UK	US HQ, Inc.	US	Open	Open	N/A	No
64	Marketing Service	12/31/2022	0	UK Ltd.	UK	US HQ, Inc.	US	Open	Open	N/A	No
65	Marketing Service	12/31/2021	0	UK Ltd.	UK	US HQ, Inc.	US	Open	Open	N/A	No

#	Transaction Type	Financial Reporting Period	Transaction Amount (USD$)	Provider of Service / Licensor	Jurisdiction of Provider / Licensor	Receiver of Service / Licensee	Jurisdiction of Receiver / Licensee	Open Year (Provider / Licensor)	Open Year (Receiver / Licensee)	Exceeds Threshold	Intra-Country Transaction
66	Loan	12/31/2023	700,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
67	Loan	12/31/2022	600,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
68	Loan	12/31/2021	670,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
69	Loan	12/31/2020	770,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No
70	Loan	12/31/2019	750,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	N/A	No
71	Loan	12/31/2018	550,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	N/A	No
72	Guarantee	12/31/2023	0	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
73	Guarantee	12/31/2022	0	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No
74	Guarantee	12/31/2021	0	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No

#	Transaction Type	Financial Reporting Period	Transaction Amount (USD$)	Provider of Service / Licensor	Jurisdiction of Provider / Licensor	Receiver of Service / Licensee	Jurisdiction of Receiver / Licensee	Open Year (Provider / Licensor)	Open Year (Receiver / Licensee)	Exceeds Threshold	Intra-Country Transaction	APA	Transfer Pricing Audit	Transfer Pricing Study	IC Agmt.	Actual Charged Reconciles to Transfer Pricing Policy	Losses	Proceed to Detailed Measurement
1	Tangible Property Sales	12/31/2023	8,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No	No	No	Yes	Yes	Yes	No	Yes
2	Tangible Property Sales	12/31/2022	7,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No	No	No	Yes	Yes	Yes	No	Yes
3	Tangible Property Sales	12/31/2021	5,500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No	No	No	Yes	Yes	Yes	No	Yes
4	Tangible Property Sales	12/31/2020	5,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	Yes	No	No	No	Yes	Yes	Yes	No	Yes
5	Tangible Property Sales	12/31/2019	3,000,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	No	No	No	No	Yes	Yes	Yes	No	No
6	Tangible Property Sales	12/31/2018	2,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	No	No	No	No	Yes	Yes	Yes	No	Yes
7	Tangible Property Sales	12/31/2023	2,000,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
8	Tangible Property Sales	12/31/2022	1,500,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
9	Tangible Property Sales	12/31/2021	1,000,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
10	Tangible Property Sales	12/31/2023	4,000,000	UK Ltd.	UK	Dutch Co.	Netherlands	Open	Open	Yes	No	No	No	Yes	Yes	Yes	Yes	Yes
11	Tangible Property Sales	12/31/2022	3,000,000	UK Ltd.	UK	Dutch Co.	Netherlands	Open	Open	Yes	No	No	No	Yes	Yes	Yes	Yes	Yes
12	Tangible Property Sales	12/31/2021	2,000,000	UK Ltd.	UK	Dutch Co.	Netherlands	Open	Open	Yes	No	No	No	Yes	Yes	Yes	Yes	Yes
13	Tangible Property Sales	12/31/2023	200,000	UK Ltd.	UK	HK Ltd.	China	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
14	Tangible Property Sales	12/31/2022	150,000	UK Ltd.	UK	HK Ltd.	China	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
15	Tangible Property Sales	12/31/2021	100,000	UK Ltd.	UK	HK Ltd.	China	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
16	Tangible Property Sales	12/31/2023	200,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
17	Tangible Property Sales	12/31/2022	150,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	No	No	No	No	Yes	Yes	Yes	No	No
18	Tangible Property Sales	12/31/2021	100,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	No	No	Yes	No	Yes	Yes	Yes	No	No
19	Intangible (Royalty)	12/31/2023	3,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	Yes	No	Yes	Yes	Yes	No	No
20	Intangible (Royalty)	12/31/2022	2,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	Yes	No	Yes	Yes	Yes	No	No
21	Intangible (Royalty)	12/31/2021	1,250,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	Yes	No	Yes	Yes	Yes	No	No
22	Intangible (Royalty)	12/31/2020	1,750,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	Yes	No	Yes	Yes	Yes	No	No
23	Intangible (Royalty)	12/31/2019	1,550,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	N/A	No	No	No	Yes	Yes	Yes	No	No
24	Intangible (Royalty)	12/31/2018	1,000,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	N/A	No	No	No	Yes	Yes	Yes	No	Yes
25	Intangible (Royalty)	12/31/2023	2,000,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No	No	Yes	Yes	Yes	Yes	No	No
26	Intangible (Royalty)	12/31/2022	1,500,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No	No	Yes	Yes	Yes	Yes	No	No
27	Intangible (Royalty)	12/31/2021	1,250,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No	No	Yes	Yes	Yes	Yes	No	No
28	Intangible (Royalty)	12/31/2023	5,000,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
29	Intangible (Royalty)	12/31/2022	3,000,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
30	Intangible (Royalty)	12/31/2021	2,000,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
31	Intangible (Royalty)	12/31/2023	0	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
32	Intangible (Royalty)	12/31/2022	0	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
33	Intangible (Royalty)	12/31/2021	0	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
34	Intangible (Royalty)	12/31/2023	0	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
35	Intangible (Royalty)	12/31/2022	0	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
36	Intangible (Royalty)	12/31/2021	0	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
37	Intangible (Royalty)	12/31/2023	5,000,000	US HQ, Inc.	US	USA Inc.	US	Open	Open	N/A	Yes	No	No	Yes	Yes	Yes	No	No
38	Intangible (Royalty)	12/31/2022	3,000,000	US HQ, Inc.	US	USA Inc.	US	Open	Open	N/A	Yes	No	No	Yes	Yes	Yes	No	No
39	Intangible (Royalty)	12/31/2021	2,000,000	US HQ, Inc.	US	USA Inc.	US	Open	Open	N/A	Yes	No	No	Yes	Yes	Yes	No	No
40	Management Service	12/31/2023	800,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes

#	Transaction Type	Financial Reporting Period	Transaction Amount (USD$)	Provider of Service / Licensor	Jurisdiction of Provider / Licensor	Receiver of Service / Licensee	Jurisdiction of Receiver / Licensee	Open Year (Provider / Licensor)	Open Year (Receiver / Licensee)	Exceeds Threshold	Intra-Country Transaction	APA	Transfer Pricing Audit	Transfer Pricing Study	IC Agmt.	Actual Charged Reconciles to Transfer Pricing Policy	Losses	Proceed to Detailed Measurement
41	Management Service	12/31/2022	750,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
42	Management Service	12/31/2021	500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
43	Management Service	12/31/2020	500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
44	Management Service	12/31/2019	500,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	N/A	No	No	No	Yes	Yes	Yes	No	No
45	Management Service	12/31/2018	500,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	N/A	No	No	No	Yes	Yes	Yes	No	Yes
46	Management Service	12/31/2023	100,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
47	Management Service	12/31/2022	100,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
48	Management Service	12/31/2021	100,000	US HQ, Inc.	US	CAN Ltd.	Canada	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
49	Management Service	12/31/2023	50,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
50	Management Service	12/31/2022	50,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
51	Management Service	12/31/2021	50,000	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
52	Management Service	12/31/2023	50,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
53	Management Service	12/31/2022	50,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
54	Management Service	12/31/2021	50,000	US HQ, Inc.	US	Brazil Ltda.	Brazil	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
55	Management Service	12/31/2023	50,000	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
56	Management Service	12/31/2022	50,000	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
57	Management Service	12/31/2021	50,000	US HQ, Inc.	US	HK Ltd.	China	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	Yes
58	Management Service	12/31/2023	25,000	UK HQ, Ltd.	UK	UK Ltd.	UK	Open	Open	N/A	Yes	No	No	Yes	Yes	Yes	No	No
59	Management Service	12/31/2022	25,000	UK HQ, Ltd.	UK	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	No
60	R&D Service	12/31/2023	2,200,000	India Pvt Ltd.	India	US HQ, Inc.	US	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	No
61	R&D Service	12/31/2022	2,000,000	India Pvt Ltd.	India	US HQ, Inc.	US	Open	Open	N/A	No	No	No	Yes	Yes	Yes	No	No
62	R&D Service	12/31/2021	1,750,000	HK Ltd.	China	US HQ, Inc.	US	Open	Open	N/A	No	No	No	Yes	No	Yes	No	No
63	Marketing Service	12/31/2023	0	UK Ltd.	UK	US HQ, Inc.	US	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
64	Marketing Service	12/31/2022	0	UK Ltd.	UK	US HQ, Inc.	US	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
65	Marketing Service	12/31/2021	0	UK Ltd.	UK	US HQ, Inc.	US	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
66	Loan	12/31/2023	700,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	No	Yes	Yes	No	Yes
67	Loan	12/31/2022	600,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	No	Yes	Yes	No	Yes
68	Loan	12/31/2021	670,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	No	Yes	Yes	No	Yes
69	Loan	12/31/2020	770,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Open	N/A	No	No	No	No	Yes	Yes	No	Yes
70	Loan	12/31/2019	750,000	US HQ, Inc.	US	UK Ltd.	UK	Closed	Closed	N/A	No	No	No	No	Yes	Yes	No	No
71	Loan	12/31/2018	550,000	US HQ, Inc.	US	UK Ltd.	UK	Open	Closed	N/A	No	No	No	No	Yes	Yes	No	Yes
72	Guarantee	12/31/2023	0	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
73	Guarantee	12/31/2022	0	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes
74	Guarantee	12/31/2021	0	US HQ, Inc.	US	Dutch Co.	Netherlands	Open	Open	N/A	No	No	No	Yes	Yes	No	No	Yes

Worksheet 3 Example of ASC 740-10-55-103 — Scenario Development

In applying the recognition criterion, an entity has determined that a tax position resulting in a benefit of $100 qualifies for recognition and should be measured. The entity has considered the amounts and probabilities of the possible estimated outcomes as follows:

Possible Estimated	Individual Probability of Occurring	Cumulative Probability of

Outcome	(%)	Occurring (%)
$100	5%	5%
$80	25%	30%
$60	25%	55%
$50	20%	75%
$40	10%	85%
$20	10%	95%
-	5%	100%

In the example above provided by the FASB in ASC 740-10-55-103, the benefit to be recorded would be $60, which is largest amount with a cumulative probability greater than 50 percent. ASC 740-10-55 does not provide any detail on the possible estimated outcomes or the basis for the individual probabilities.

Accounting Policy & Practice Portfolios: Accounting for Income Taxes
Portfolio 5004-2nd: Accounting for Income Taxes: Uncertain Tax Positions in Transfer Pricing
Working Papers

Worksheet 4 Unit of Account Definition Support

Unit of Account Numbers	General description of tax uncertainties addressed	Description of how Unit of Account are defined	How definition corresponds to the manner in which the enterprise prepares and supports its income tax return	How definition corresponds to approach the enterprise anticipates the taxing authorities will take during an examination	How definition considers the individual facts and circumstances of such positions evaluated in light of all available evidence
1-10	Transfer Pricing	Annual amounts charged for given transaction types between pairs of legal entities	Forms 5471 and 5472 are prepared on an annual basis; separate line items for royalties, property, and interest are disclosed. Transfer pricing documentation reports that support the tax return are organized in the same way.	Audits structured on annual basis, methodologies differ by transaction type, assumes tax authorities will follow organization of transfer pricing documentation reports when making any challenges.	Definitions consider comparables appropriate to each transaction type, each year, and each jurisdiction

11	R&D Tax Credit				
12-25	…				
26-50	…				
51-100	…				