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The Total Costs of Transfer Pricing Disputes: Higher Than You Think

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Transfer pricing is the largest tax issue for multinationals, both in absolute size and in proportion to other tax issues. When tax professionals speak about transfer pricing disputes, the description of the costs of those disputes is sometimes limited to the explicit costs of the tax, penalties and interest resulting from a sustained adjustment. Other costs of transfer pricing disputes are not as easily tracked but are nonetheless real costs. This article will address both.

Penalty rules and global enforcement efforts already encourage taxpayers to maintain documentation. However, a better appreciation of the total costs of transfer pricing disputes might incentivize taxpayers to maintain robust, consistent, transparent transfer pricing documentation and consider advance pricing agreements to avoid transfer pricing disputes. An ounce of prevention is worth a pound of cure.

EXPLICIT COSTS

Taxes. Transfer pricing is the largest tax issue for most multinationals, large or small. For decades, tax executives when asked what tax issues cause them the

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greatest concern have said transfer pricing. Many of the largest U.S. tax disputes have been transfer pricing disputes, including the 2020 Tax Court transfer pricing decision against Coca-Cola Co. which resulted in a \$9 billion transfer pricing adjustment.¹ Three transfer pricing cases have been decided or settled in the last year — *Medtronic*, *Eaton*, and *Caterpillar* — two of them with over \$1 billion in dispute.²

Penalties. Section 6662(e) and §6662(h) impose 20% and 40% penalties for transfer pricing valuation misstatements which produce an increase in U.S. income tax. Amounts are excluded from the calculation to the extent the taxpayer applied one of the transfer pricing methods in the §482 regulations in a reasonable manner.³ The penalties tend to be large, consistent with the size of the transfer pricing adjustments.

Interest. There are no special interest rules for transfer pricing; however, the amounts of additional taxes and penalties combined with the long time for resolution of cases produces exceedingly large interest amounts. According to OECD statistics, transfer pricing cases in the mutual agreement procedure take nearly twice as long to resolve as non-transfer pricing cases.⁴ The earliest years addressed in the *Coca-Cola*,

¹ *Coca-Cola Co. v. Commissioner*, 155 T.C. 10 (U.S.T.C. 2020) (\$9 billion income adjustment for 2007–09). The taxpayer has indicated that it will appeal. Should the Tax Court decision be affirmed, the taxpayer estimates a potential tax deficiency of \$13 billion through tax year ending December 2021. The Coca-Cola Co., Form 10-Q for quarter ending July 1, 2022.

² See *Medtronic v. Commissioner*, T.C. Memo 2022-84 (Aug. 18, 2022) (approximately \$1.4 billion in adjustments for 2005–06); *Eaton Corp. v. Commissioner*, No. 21-1569 (6th Cir. Aug. 25, 2022) (approximately \$125 million in tax adjustments and penalty for tax years 2005–06); and a settlement between Caterpillar and IRS involving a transfer pricing dispute for 2007–16 (the proposed adjustment for 2007–12 was over \$2.3 billion).

³ §6662(e)(3)(B)(i). Note that these methods are referred to as “specified methods” in the regulations for this section.

⁴ <https://www.oecd.org/ctp/dispute/mutual-agreement->

Medtronic, Eaton, and Caterpillar cases were 2007, 2005, 2005, and 2007, respectively.

OTHER COSTS

The other costs of transfer pricing disputes are not specifically identified in the financial statements, but are, nonetheless, quite large. First, professional fees for transfer pricing disputes are dramatically higher than for any other tax disputes. Next, in-house professionals spend considerably more time and expense managing transfer pricing information and participating in the resolution of transfer pricing disputes. Finally, the impact of adverse media coverage and distraction of high-level executives represent real costs of transfer pricing disputes. Most of these costs are incurred whether the taxpayer wins or loses.

PROFESSIONAL FEES

Professional fees are not specifically reported for transfer pricing or other tax disputes. Even without specific financial information or a review of the team makeup, the processes for incremental resolution and remediation present a compelling case that the professional fees for transfer pricing disputes far exceed those for other tax disputes — compounded by the exceedingly long time required to resolve transfer pricing disputes.

First, transfer pricing is a valuation issue, and valuation cases are expensive to develop and defend. The arm's-length comparison of controlled transaction to uncontrolled transactions requires a substantial amount of transactional data and analysis. The government and taxpayer teams each typically employ professionals across all three disciplines involved in transfer pricing: legal, accounting, and economics.

Next, the cross-border nature of the transfer pricing more than doubles the cost of negotiating such disputes and amending returns for any sustained adjustment. Unlike other tax issues, transfer pricing disputes require agreement between the taxpayer and at least two tax authorities. The procedures to resolve transfer pricing between countries and achieve correlative relief for the taxpayer are complex and expensive due to the size, complexity and ambiguity of transfer pricing issues as well as the need to satisfy at least two countries.

Even after resolution of a transfer pricing dispute, the process to amend tax returns is more complicated and expensive than other tax issues. Once the IRS, the other country's tax authority, and the taxpayer agree on transfer pricing adjustments, the taxpayer must file

procedure-statistics.htm.

amended returns reflecting those adjustments for each affected year in each country. Since a change in U.S. federal taxable income generally affects the state tax base, amended state tax returns are also likely. And companies that use transfer pricing analysis to value goods for Customs purposes may need to revise their Customs filings.

Finally, the transfer price developed for tax purposes must agree with that used in financial reporting. Taxpayers are required to allocate funds to “conform” their financial accounts so that they agree with the transfer pricing finalized for tax purposes.⁵ This conforming allocation may trigger secondary tax treatment of an allocated amount as a dividend or capital contribution, or possibly as deemed intercompany indebtedness.⁶ In any event, this type of effort is well beyond that required in connection with other tax issues.

The combination of multi-discipline teams, cross-border resolution and remediation, and the need to conform taxpayer books results in professional fees well in excess of that for other tax issues.

IN-HOUSE COSTS

The need for transactional information and responses to information requests throughout a transfer pricing dispute places a tremendous burden on in-house personnel. When Apple Computer signed the first advance pricing agreement in 1991, Eric Ryan, Apple's then-director of taxes, remarked that it would have taken “three boxcars of information” if the issue had to be resolved through litigation.⁷ As discussed above, the cross-border nature requires the involvement of in-house personnel on each side of the transaction and amended returns in each jurisdiction. Further, the need to “conform” taxpayer accounts following a sustained transfer pricing adjustment requires additional effort.⁸

IMPACT ON NON-TAX ISSUES

The sheer size of transfer pricing issues can easily adversely impact a company beyond tax aspects. Such large disputes often draw unwelcome attention in tax publications and broader business media.⁹ The additional media attention can cause distraction to C-suite executives and possibly investor concern.

⁵ Reg. §1.482-1(g)(3).

⁶ *Id.*

⁷ K. Matthews and E. Emily, *For Apple Computer, An APA Helps Keep Auditing Nightmares Away*, 51 Tax Notes 280 (April 1991).

⁸ Reg. §1.482-1(g)(3).

⁹ Robert Willens, *Coca-Cola Failed to Charge Arm's-Length Royalties to Affiliates*, Daily Tax Rpt. Dec. 15, 2020; Vanessa

CONCLUSION

The exposure to additional tax, penalties and interest is generally a quantifiable risk. The other costs as-

Holder, *Apple's €13BN Bill Swamps Its EU Tax Filings*, Fin. Times, Aug. 31, 2016; Patrick Temple-West, *Caterpillar's Swiss Unit Dodged \$2.4 Billion of U.S. Taxes: Senate Panel*, Reuters, Mar. 31, 2014.

sociated with transfer pricing disputes — enormous professional fees, internal efforts and costs, executive distraction, and unwelcome media attention — are much more difficult to quantify, but no less real. Multinationals would do well to thoroughly evaluate their global exposure to transfer pricing disputes and develop strategies to reduce risk and avoid transfer pricing disputes.