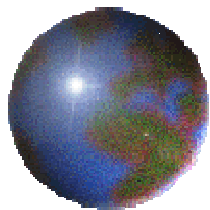


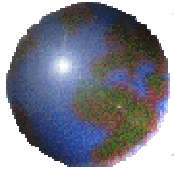


# *Transfer Pricing Adjustments*



**Chiu & Wang, Inc.**  
Premier Tax Services

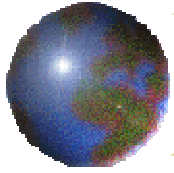
July 3, 2006



## IRS Circular 230 Disclosure:

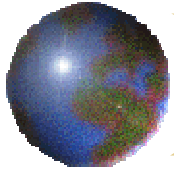
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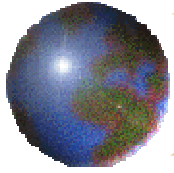
# *Transfer pricing penalties*

- A 20% or 40% penalty is imposed on any underpayment of tax attributable to a substantial valuation misstatement pertaining to either a transaction between related parties (the transactional penalty) or a net transfer pricing adjustment (the net adjustment penalty).
- Transactional penalty:
  - Substantial valuation misstatement (20%): Price for property or service claimed is 200% or more (or 50% or less) of arm's-length price
  - Gross valuation misstatement (40%): 400% or more (or 25% or less)
- Net adjustment penalty:
  - Substantial valuation misstatement (20%): Net adjustment is greater than the lesser of \$5 million or 10% of gross receipts
  - Gross valuation misstatement (40%): \$20 million or 20% of gross receipts



## *What adjustments?*

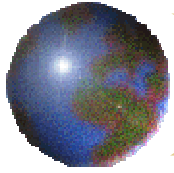
- ❖ Primary adjustment
- ❖ Correlative allocation
  - ❑ An adjustment with respect to other member of the group affected by the primary adjustment
- ❖ Setoff
  - ❑ A setoff of other non-arm's-length transactions
- ❖ Secondary adjustment
  - ❑ An adjustment made to conform to taxpayer's accounts to reflect primary adjustment made.



# Example

- Foreign parent sells product to its US subsidiary for resale to US customers.

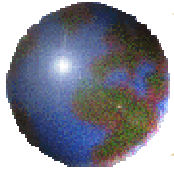
<b>Before primary adjustment:</b>		
Sales	100,000	
COGS	(80,000)	
Gross profits	20,000	
Operating expenses	(28,000)	
Net income	(8,000)	-8%
Tax rate	34%	
Tax	-	



## *Example - continued*

- After a transfer pricing study is done, a primary adjustment of \$10,500 is made to COGS.

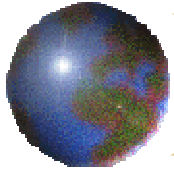
<b>After primary adjustment:</b>		
Sales	100,000	
COGS	(69,500)	
Gross profits	30,500	
Operating expenses	(28,000)	
Net income	2,500	3%
Tax rate	34%	
Tax	850	



## *Example - continued*

- The adjustment is booked as follows:

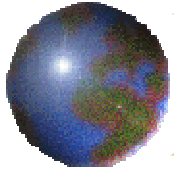
Dr.	A/P	\$10,500	
	Cr.	COGS	\$10,500
Dr.	Tax expense	\$850	
	Cr.	Tax payable	\$850



## *What will happen if the adjustment is not booked?*

- ❖ Because of the primary adjustment, US Sub holds fictional excess cash of \$10,500.
- ❖ The fictional excess cash will be deemed distributed to the foreign parent.
- ❖ If US Sub has sufficient earning and profits after the primary adjustment, the deemed distribution is subject to a 30% withholding tax as dividend distribution.

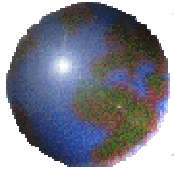




## *Any cure for the secondary adjustment?*

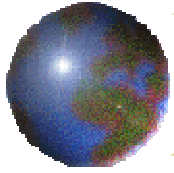
### ❁ Revenue Procedure 99-32

- ❁ An interest-bearing account receivable is deemed to have been created as of the last day of the year for which the primary adjustment is made
- ❁ Such account is paid within 90 days of the date on which the taxpayer files the return reporting the primary adjustment
- ❁ Such account can be offset against a bona fide debt between taxpayer and the related party
- ❁ This is an election that has to be made on the tax return that reports the primary adjustment



## *What will happen if the IRS makes the primary adjustment?*

- ❖ Potential transfer pricing penalties
  - ❑ Can be avoided if contemporaneous documentation (transfer pricing study) is provided within 30 days of the request
- ❖ Potential secondary adjustment
  - ❑ Deemed dividend
- ❖ File a request to follow Rev. Proc. 99-32 in writing with the IRS before closing action is taken on the primary adjustment



# Q&A