

# **The Section 6662(e) Substantial and Gross Valuation Misstatement Penalty**

## *A Presentation and Tutorial Guide of the Code and Regulations*

### **What Is the Transfer Pricing Penalty?**

Though we generally refer to a penalty arising from an I.R.C. ' 482 adjustment as a transfer pricing or as an I.R.C. ' 6662(e) penalty, its real name is the substantial and gross valuation misstatement penalty, under I.R.C. ' ' 6662(a), (e) and (h).

I.R.C. ' 6662 contains the provisions for the imposition of accuracy-related penalties. I.R.C. ' ' 6662(b)(3) and 6662(e) describe the substantial valuation misstatement penalties. I.R.C. ' 6662(e)(1)(B) provides that certain adjustments made under I.R.C. ' 482 are subject to accuracy-related penalties. I.R.C. ' 6662(a) imposes a 20% addition-to-tax penalty on the portion of the underpayment of tax attributable to the accuracy-related penalties. I.R.C. ' 6662(h) increases the accuracy-related penalty to 40% under certain circumstances, including gross valuations misstatements, which include some adjustments made under I.R.C. ' 482.

### **When Does the Transfer Pricing Penalty Apply?**

The penalties described in I.R.C. ' 6662(e) apply whenever there is an **underpayment of tax attributable to a valuation misstatement**, subject to certain thresholds.

In any year, no penalty is imposed under these rules unless the underpayment of tax attributable to all valuation misstatements exceeds a dollar limitation of \$5,000 in the case of an individual, S corporation and personal holding companies (as defined by I.R.C. ' 542) or \$10,000 in the case of a corporation. I.R.C. ' 6662(e)(2). This dollar limitation must be met for each year in which the penalty will be asserted, including carryback and carryover years of any valuation misstatements. Treas. Reg. ' \_1.6662-5(b).

**The I.R.C. ' 6662(e)(1)(B) and (h) penalty provisions are applicable to any tax year ending after November 5, 1990.**

Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, Title XI, sec. 11312, 104 Stat. 1388 (1990). The documentation requirements that we will discuss later are only applicable to tax years beginning after December 31, 1993. Also note, the thresholds changed for 1994.

## How Is the Transfer Pricing Penalty Applied?

There are two ways for a substantial or gross valuation misstatement penalty to attach to I.R.C. ' 482 adjustments.

1. **Transactional Penalty** is described in I.R.C. ' 6662(e)(1)(B)(i) and Treas. Reg. ' 1.6662-6(b).

This penalty is raised when the Service determines under I.R.C. ' 482 that the price for any property or services claimed on the return is 200% more or 50% less than the correct price.

2. **Net-adjustment Penalty** is described in I.R.C. ' 6662(e)(1)(B)(ii) and Treas. Reg. ' 1.6662-6(c).

This penalty is raised when the Service determines that the net of adjustments made under I.R.C. ' 482 exceeds the lesser of \$5 million or 10% of taxpayer gross receipts for the taxable year.

## What Makes The Penalties Gross?

I.R.C. ' 6662(h) substitutes language in I.R.C. ' 6662(e) for both the transactional and net adjustment penalty.

In the case of the **transactional penalty**, the penalty rate is increased to 40% when the price for any property or services claimed on the return is 400% more or 25% less than the correct price.

In the case of a **net adjustment penalty**, the penalty is increased to 40% when the net of adjustments made under I.R.C. ' 482 exceeds the lesser of \$20 million or 20% of the taxpayer's gross receipts for the taxable year.

- \$ Determining the transfer pricing penalty
- \$ How do you know when a transfer pricing penalty may apply?
- \$ How do the transfer pricing penalties interact with other penalties?
- \$ How do you calculate the actual penalty amount?
- \$ How do you know when a transfer pricing penalty may apply?

**Begin with the adjustments made pursuant to I.R.C. ' 482.**

Let's examine a few different scenarios. In these scenarios, we will examine when a penalty may apply. Later, we will go through all the steps of calculating the actual penalty amount. Also, keep in mind that right now we are looking at what type of adjustments meet the initial thresholds of I.R.C. ' 6662(e).

Later we will see that some of these adjustments may be excluded from the penalty computation based upon compliance with the reasonable cause and good faith exception and the contemporaneous transfer pricing documentation requirements.

**Example:** USCO manufactures Widgets and transfers them to CFCs worldwide. USCO's COGS is \$6. USCO reported income based upon a transfer price of \$10 for each Widget, or \$4 of gross profit per Widget sold.

**CASE 1:** USCO sold 1 million Widgets and reported \$4 million of net income. The Service determines that the price per Widget should have been \$13. The Service's allocation and adjustment increases USCO's net income by \$3 million.

\*Note: For all examples, assume USCO has substantial gross receipts and that the 10% and 20% gross receipts tests for the net adjustment penalty under § 6662(e) & (h) are NOT satisfied. **Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

No, the adjustment does not meet the requirements of either the transactional penalty or the net adjustment penalty.

**Example:** USCO manufactures Widgets and transfers them to CFCs worldwide. USCO's COGS is \$6. USCO reported income based upon a transfer price of \$10 for each Widget, or \$4 of gross profit per Widget sold.

**CASE 2:** USCO sold 25,000 Widgets and reported \$100,000 of net income. The Service determines that the price per Widget should have been \$21. The Service's allocation and adjustment increases USCO's net income by \$275,000.

**Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

Yes, a 20% transactional penalty applies because the adjustment reflects that the correct price under I.R.C. ' 482 is greater than 200% of the amount USCO claimed on its return. The net adjustment penalty does not apply in this case, as the adjustment is less than \$5 million.

**Example:** USCO manufactures Widgets and transfers them to CFCs worldwide. USCO's COGS is \$6. USCO reported income based upon a transfer price of \$10 for each Widget, or \$4 of gross profit per Widget sold.

**CASE 3:** USCO sold 1.8 million Widgets and reported \$7.2 million of net income. The Service determines that the price per Widget should have been \$13. The Service's allocation and adjustment increases USCO's net income by \$5.4 million.

**Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

Yes, the net adjustments pursuant to I.R.C. ' 482 are greater than \$5 million, therefore a 20% penalty is added to the additional tax due.

*Note, in this example, the transactional based penalty thresholds were not met; the price discrepancy was small, it was the volume of the transactions that warranted the application of a 20% net adjustment penalty.*

**Example:** USCO manufactures Widgets and transfers them to CFCs worldwide. USCO's COGS is \$6. USCO reported income based upon a transfer price of \$10 for each Widget, or \$4 of gross profit per Widget sold.

**CASE 4:** USCO sold 1.8 million Widgets and reported \$7.2 million of net income. The Service determines that the price per Widget should have been \$21. The Service's allocation and adjustment increases USCO's net income by \$19.8 million.

**Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

Yes, in this case the thresholds for both the transactional penalty and net adjustment penalty are both met at the 20% penalty rate.

*Note, that there are not two applications of the penalty. As we will see later, there is an advantage to characterizing any underpayment of tax from this adjustment under the net adjustment penalty because there are higher standards to be excepted from penalty application under the reasonable cause and good faith exception requirements of I.R.C. ' 6664(c).*

**Example:** USCO manufactures Widgets and transfers them to CFCs worldwide. USCO's COGS is \$6. USCO reported income based upon a transfer price of \$10 for each Widget, or \$4 of gross profit per Widget sold.

**CASE 5:** USCO sold 200,000 HITEC Widgets, which includes valuable proprietary technology protected under several patents. USCO reported \$800,000 of net income from the transactions. The Service determines that the price per HITEC Widget should have been \$41. The Service's allocation and adjustment increases USCO's net income by \$6.2 million.

**Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

Yes, in this case the thresholds for both the transactional penalty and net adjustment penalty are met. Furthermore, under the transactional penalty the Service's determination of the correct price was 410% of the price USCO claimed on its return. Pursuant to I.R.C. ' 6662(h), the transactional penalty is increased to 40% of the underpayment of tax attributable to this valuation misstatement. The net adjustment penalty applied because the net I.R.C. ' 482 adjustment is greater than \$5 million, but it would be an alternative position to the transactional penalty in this case.

**Example:** USCO manufactures Widgets and transfers them to CFCs worldwide. USCO's COGS is \$6. USCO reported income based upon a transfer price of \$10 for each Widget, or \$4 of gross profit per Widget sold.

**CASE 6:** USCO sold 8 million Widgets and reported \$32 million of net income. The Service determines that the price per Widget should have been \$13. The Service's allocation and adjustment increases USCO's net income by \$24 million.

**Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

Yes, the net adjustments pursuant to I.R.C. ' 482 are greater than \$5 million, therefore the net adjustment penalty applies. I.R.C. ' 6662(h) increases the penalty rate from 20% to 40% in cases where the net I.R.C. ' 482 adjustments exceed \$20 million. Again, the transactional based penalty thresholds were not met; the gross valuation misstatement applies in this case because the overall volume of the transactions warranted the application of a 40% net adjustment penalty.

- \$ How do you calculate the actual penalty amount?
- \$ What do you do when there are penalties other than transfer pricing penalties asserted against the taxpayer for same tax year?
- \$ What do you do when there are net operating loss (ANOL@) carryforwards or carrybacks in the year in which the substantial or gross valuation misstatement occurred?

## Interaction With Other Penalties And NOLs

### Multiple penalties on the same adjustment?

The maximum accuracy-related penalty imposed on a portion of an underpayment may not exceed 20 percent of such portion (40 percent of the portion attributable to a gross valuation misstatement per I.R.C. ' 6662(h)), notwithstanding that such portion is attributable to more than one type of misconduct. Treas. Reg. ' 1.6662-2(c). The same underpayment of tax may simultaneously be attributable to negligence (I.R.C. ' 6662(b)(1)), a substantial understatement of tax (I.R.C. ' 6662(b)(2)), and a substantial valuation misstatement (I.R.C. ' 6662(b)(3)), but only one penalty will result at the highest applicable rate. Interaction with other penalties and NOLs

### Multiple I.R.C. ' 482 adjustments?

In the case of multiple I.R.C. ' 482 adjustments to which the transfer pricing penalties apply, one must consider the coordination rules under Treas. Reg. ' 1.6662-6(f). Treas. Reg. ' 1.6662-6(f) sets forth rules for coordinating between the 20 percent substantial valuation misstatement penalty and the 40 percent gross valuation misstatement penalty when both the transactional and net adjustment penalty are present.

Let's examine how multiple adjustments made under I.R.C. ' 482 effect which penalties apply.

**Example** USCO manufactures Widgets and Round-to-itz and transfers them to CFCs worldwide. USCO's COGS for the Widgets is \$6, and the USCO's COGS sold for the Round-to-itz is \$9. USCO reported income based upon a transfer price of \$10 for each Widget, or \$4 of gross profit per Widget sold. USCO reported income based upon a transfer price of \$20 for each Round-to-itz, or \$11 of gross profit per Round-to-itz sold.

**CASE 7:** USCO sold 50,000 HITEC Widgets, which includes valuable proprietary technology protected under several patents. USCO reported \$200,000 of net income from the transactions.

(Adjustment 1). The Service determines that the price per HITEC Widget should have been \$41. The Service's allocation and adjustment increases USCO's net income by \$1,550,000

(Adjustment 2). USCO also sold 500,000 Round-to-itiz. USCO reported \$5,500,000 of net income from the transactions. The Service determines that the price per Round-to-itiz should have been \$28. The Service's allocation and adjustment increases USCO's net income by \$4,000,000

**Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

Yes. Under the net adjustment penalty provisions, the threshold is met by adding Adjustment 1 and Adjustment 2 together. The net I.R.C. ' 482 adjustments equal \$5,550,000, which is greater than the \$5 million threshold, therefore the 20% net adjustment penalty applies.

*Note, however, that the Service's determination of the correct price in Adjustment 1 is 410% of the price USCO claimed on its return. Adjustment 1 independently satisfies the transactional penalty and pursuant to I.R.C. ' 6662(h), the penalty rate is increased to 40% of the underpayment of tax attributable to this valuation misstatement. This does not affect whether Adjustment 2 is still subject to the 20% net adjustment penalty. As we will see later, the penalty coordination rules determine that Adjustment 1 is subject to a 40% transactional penalty and Adjustment 2 is subject to the 20% net adjustment penalty.*

**CASE 8:** USCO sold 500,000 HITEC Widgets, which includes valuable proprietary technology protected under several patents. USCO reported \$2,000,000 of net income from the transactions. The Service determines that the price per HITEC Widget should have been \$41.

(Adjustment 1). The Service's allocation and adjustment increases USCO's net income by \$15,500,000

(Adjustment 2) USCO also sold 600,000 Round-to-itiz. USCO reported \$6,600,000 of net income from the transactions. The Service determines that the price per Round-to-itiz should have been \$28. The Service's allocation and adjustment increases USCO's net income by \$4,800,000.

**Is there a transfer pricing penalty pursuant to I.R.C. ' 6662(e)?**

Yes. Under the net adjustment penalty provisions, the threshold is met by adding Adjustment 1

and Adjustment 2 together. The net I.R.C. ' 482 adjustments equal \$20,300,000, which is greater than the \$5 million threshold, therefore the net adjustment penalty applies. Pursuant to I.R.C. ' 6662(h) the net adjustment penalty rate is increased to 40% where the net I.R.C. ' 482 adjustments exceed \$20 million.

*Note, although the Service's determination of the correct price in Adjustment 1 is 410% of the price USCO claimed on its return only the net adjustment penalty is asserted. Interaction with other penalties and NOLs*

### **Multiple adjustments for which accuracy-related and fraud penalties may apply?**

Treas. Reg. ' 1.6664-3 provides rules for determining the order in which multiple adjustments to a return are taken into account for the purpose of computing the total amount of penalties imposed under I.R.C. ' ' 6662 and 6663. These ordering rules do not make any exception for, or distinction between, penalties based upon I.R.C. ' 482 adjustments. Treas. Reg. ' 1.6664-3(a) provides that the ordering rules of subsection 3(b) apply where (1) there is at least one adjustment with respect to which no penalty has been imposed and at least one with respect to which a penalty has been imposed, or (2) there are at least two adjustments with respect to which penalties have been imposed and they have been imposed at different rates.

Treas. Reg. ' 1.6664-3(b) provides that adjustments are considered made in the following order:

- (1) Those with respect to which no penalties have been imposed.
- (2) Those with respect to which a penalty has been imposed at a 20 percent rate (*i.e.*, a penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, or substantial valuation misstatement, under I.R.C. ' ' 6662(b)(1) through 6662(b)(3), respectively).
- (3) Those with respect to which a penalty has been imposed at a 40 percent rate (*i.e.*, a penalty for a gross valuation misstatement under I.R.C. ' ' 6662(b)(3) and (h)).
- (4) Those with respect to which a penalty has been imposed at a 75 percent rate (*i.e.*, a penalty for fraud under I.R.C. ' 6663).

### **Calculating the penalty amount in the case of a NOL?**

Treas. Reg. ' 1.6662-6(e) sets forth special rules for carrybacks and carryovers:

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, I.R.C. ' 482 valuation misstatements made in one year that give rise to an underpayment of tax in a prior or subsequent year are not grouped with misstatements made in that prior or subsequent year for purposes of determining whether the valuation misstatement is substantial or gross in nature. The character and penalty rate of the misstatement are determined in the year the misstatement is made, not in any other year in which the misstatement gives rise to an underpayment of tax.

**Example:** Now that we have examined some of the rules, let's look at some examples for determining whether there is an underpayment of tax.

**CASE 9:** Assume a domestic corporation reported a current year loss on an originally filed income tax return. Upon audit, both a I.R.C. ' 482 and a non-I.R.C. ' 482 adjustment are proposed. The I.R.C. ' 482 adjustment constitutes a substantial valuation misstatement under I.R.C. ' 6662(e)(1)(B), *i.e.*, the dollar or percentage thresholds are met. This misstatement is subject to the 20 percent penalty under I.R.C. ' 6662(a). The non-I.R.C. ' 482 adjustment is not subject to any penalties.

**In what order are current year losses absorbed by adjustments?**

**Are adjustments with penalties absorbed first or last?**

**Let's assume the following facts:**

- |  |                      |
|--|----------------------|
| • Taxable income or <loss> per return                | \$ <10,000,000>      |
| • Non-I.R.C. ' 482 adjustment                        | \$ 20,000,000        |
| • I.R.C. ' 482 adjustment (subject to 6662(e)(1)(B)) | <u>\$ 15,000,000</u> |
| • Total adjustments                                  | \$ 35,000,000        |
| • Taxable income, as corrected                       | \$ 25,000,000        |

**Lastly assume that the effective income tax rate is 35 percent. This is done in the interest of simplicity; however, Treas. Reg. ' 1.6664-3(d)**

*Example 1* uses graduated income tax rates to calculate the portion of the understatement of income tax attributable to each adjustment. See Lemishow v. Commissioner, 110 T.C. 346 (1998).

Examples as discussed above, Treas. Reg. ' 1.6664-3 applies in determining the order in which multiple adjustments are taken into account for purposes of computing I.R.C. ' 6662 and 6663 penalties. The calculation of the penalty is as follows:

**Step 1:** Adjustments not subject to a penalty

The first step is to calculate the amount of the underpayment of tax attributable to adjustments not subject to a penalty, which in this case is the non-I.R.C. ' 482 adjustment.

1.	Taxable income or <loss> per return	\$<10,000,000>
2.	Adjustment 1: non-I.R.C. ' 482 adjustment	<u>\$ 20,000,000</u>
3.	Adjusted taxable income, as corrected	\$ 10,000,000.

Here, the \$10,000,000 loss is absorbed against the adjustment for which there is no penalty.

**Step 2:** Adjustments subject to a 20 percent penalty

The next step is to determine the amount of underpayment of tax attributable to adjustments subject to 20 percent penalties. In this case, the I.R.C. ' 482 adjustment is the only adjustment subject to a 20 percent penalty. Starting with the adjusted taxable income, as corrected, from Step 1, one determines the total taxable income, as corrected, with the 20 percent penalty adjustments.

4.	Adjusted taxable income (from line 3)	\$ 10,000,000
5.	Adjustment 2 - I.R.C. ' 482 adjustment	<u>\$ 15,000,000</u>
6.	Total taxable income, as corrected	\$ 25,000,000

**Step 3:** Calculation of underpayment

Next, the underpayment of tax attributable to the 20 percent penalty adjustment is determined. The underpayment is determined by calculating the tax on the total taxable income, as corrected, determined in Step 2 and subtracting from that amount the tax determined in Step 1 for adjustments on which no penalty was asserted.

7.	Income tax on corrected taxable income (35% of \$25,000,000)	\$ 8,750,000
8.	Tax on Adjustment 1 (35% of \$10,000,000)	<u>\$ 3,500,000</u>
9.	Underpayment of tax from Adjustment 2	\$ 5,250,000

**Step 4:** Calculation of Penalty

Next, the amount of the penalty is determined by multiplying the penalty rate times the underpayment of tax determined in Step 3.

10.	Underpayment of tax from Adjustment 2	\$ 5,250,000
11.	Penalty rate	<u>20%</u>
12.	Penalty amount	\$ 1,050,000

The underpayment of income tax that is attributable to the I.R.C. ' 482 adjustment of \$15,000,000 is \$5,250,000. Once the amount of the underpayment of tax is determined, the appropriate penalty rate is multiplied by the underpayment to determine the penalty (addition to tax) from this valuation misstatement, which is \$1,050,000 in this example.

**Example:** Let's look at another example where current year adjustments do not exceed the loss reported on the taxpayer's return.

**Case 10:** Assume a domestic corporation reported a current year loss on an originally filed income tax return. On audit, a I.R.C. ' 482 adjustment is proposed. Although the adjustment does not overcome the loss on the return as filed, the I.R.C. ' 482 adjustment constitutes a substantial valuation misstatement under I.R.C. ' 6662(e)(1)(B), *i.e.*, the dollar or percentage thresholds are met. Thus the misstatement is subject to the 20 percent penalty under I.R.C. ' 6662(a).

**How is the penalty calculated in the following example?**

- Taxable income or <loss> per on return \$ <10,000,000>
- I.R.C. ' 482 adjustment \$ 8,000,000
- Taxable income or <loss>, as corrected \$ <2,000,000>

Here, the proposed I.R.C. ' 482 adjustment does not exceed the current year loss. Under I.R.C. ' 6662(a), a I.R.C. ' 6662 penalty can not be applied in a year where there is no underpayment of income tax. I.R.C. ' 6664(a), Treas. Reg. ' ' 1.6662-2(a) and 1.6664-2. Although there is no underpayment of income tax attributable to the substantial valuation misstatement for the current tax year, the substantial valuation misstatement may give rise to an underpayment of tax in a prior or subsequent tax year. The next example addresses such a situation.

**Example:** In this example we will also apply a NOL carryforward from a prior year to the current year.

**CASE 11:** Assume a domestic corporation reported current year income on an originally filed income tax return, but the taxable income is reduced to zero by a NOL carryforward from a prior year. On audit, a I.R.C. ' 482 adjustment is

proposed. The I.R.C. ' 482 adjustment constitutes a substantial valuation misstatement under I.R.C. ' 6662(e)(1)(B), *i.e.*, the dollar or percentage thresholds are met. Thus the misstatement is subject to the 20 percent penalty under I.R.C. ' 6662(a).

**Assuming the adjustment does not overcome the NOL carryforward, may the I.R.C. ' 6662(e)(1)(B) penalty be calculated and imposed?**

**For example, assume:**

- Taxable income for Year 2 per return \$ 10,000,000
- NOL carryforward from Year 1 per return \$ <30,000,000>
- Adjusted taxable income or <loss> per return \$ <20,000,000>
- I.R.C. ' 482 adjustments to Year 2 taxable income \$ 18,000,000
- Adjusted taxable income for Year 2, as corrected \$ <2,000,000>

No penalty may be calculated in Year 2 because, as in the prior example, CASE 10, there is no underpayment of tax attributable to a substantial or gross valuation misstatement due to the NOL carryforward.

Although no penalty attaches to the valuation misstatement in Year 2 because there is no underpayment of income tax, there may be a penalty in a year prior or subsequent to Year 2. Treas. Reg. ' 1.6662-6(e) addresses situations where a NOL carryforward (or carryback) is attributable to a substantial or gross valuation misstatement which gives rise to an underpayment of tax in another year.

In Year 2, the taxpayer's valuation misstatement reduced taxable income (before application of the Year 1 NOL) from \$28,000,000 (as corrected for the Year 2 return) to \$10,000,000 (per Year 2 return). Although this valuation misstatement did not create an underpayment of income tax in Year 2, a taxpayer might carry over the balance of the NOL as reported, \$<20,000,000>, instead of the balance of the NOL as corrected, \$<2,000,000>, and apply this amount against another year's taxable income. An underpayment of income tax attributable to the Year 2 valuation misstatement in Year 3 will exist if taxpayer offsets such taxable income through application of a residual NOL in an amount greater than \$2,000,000. Treas. Reg. ' 1.6662-6(e).

For example, assume the same taxpayer had \$35,000,000 of current year income in Year 3, that the effective tax rate is 35 percent and a I.R.C. ' 6662(e)(1)(B) penalty is imposed at the 20 percent rate:

- Taxable income for Year 3 per return \$ 35,000,000

- NOL carryforward from Year 2 per return \$ <20,000,000>
- Adjusted taxable income for Year 3 per return \$ 15,000,000
- NOL carryforward attributable to Year 2
- I.R.C. ' 482 valuation misstatement \$ 18,000,000
- Adjusted taxable income for Year 3, as corrected \$ 33,000,000

Assuming no other adjustments, the underpayment of income tax in Year 3 attributable to the Year 2. **I.R.C. ' 482 valuation misstatement is calculated as follows:**

- Adjusted taxable income for Year 3, as corrected \$ 33,000,000
- Less adjusted taxable income for Year 3, per return \$ 15,000,000
- Understatement of taxable income for Year 3 \$ 18,000,000

**The penalty imposed in Year 3 is calculated as follows:**

- Income tax on corrected taxable income \$ 11,550,000 (35% of \$33,000,000)
- Tax on Year 3 taxable income, per return \$ 5,250,000 (35% of \$15,000,000)
- Underpayment of income tax in Year 3 \$ 6,300,000
- Penalty rate 20%
- Penalty amount \$ 1,260,000

**In the above example,** the valuation misstatement made in Year 2 did not have a tax underpayment effect until Year 3 when the overstated NOL carryforward improperly reduced taxable income and consequently gave rise to an underpayment of income tax for Year 3. Pursuant to the rules in Treas. Reg. ' 1.6662-6(e), the valuation misstatement penalty is imposed in the year in which the underpayment of tax related to the misstatement occurs, *i.e.*, Year 3 in this example. In this case the NOL carried from Year 1 to Year 2 is valid, but the NOL carried from Year 2 to Year 3 was, in part, attributable to a I.R.C. ' 482 valuation misstatement.

Therefore, for Year 3, the valuation misstatement penalty is equal to the penalty rate multiplied by the underpayment of tax attributable to the Year 2 valuation misstatement giving rise to the underpayment of tax in Year 3. In this case, the entire understatement of \$18,000,000 was improperly absorbed in Year 3 and gave rise to an underpayment of tax.

**Is there a way out of the penalty?**

Yes. I.R.C. ' 6664(c) sets forth the reasonable cause exception applicable to penalties asserted

under I.R.C. ' 6662 and 6663. I.R.C. ' 6664(c) generally provides that no penalty shall be imposed on any portion of underpayment of tax if the taxpayer had reasonable cause and acted in good faith with respect to that portion of the underpayment. This is known as the reasonable cause and good faith exception. Treas. Reg. ' 1.6664-4 defines the reasonable cause and good faith exception and demonstrates the requirements necessary to qualify for this general exception.

### **Exception for the Transactional Penalty**

**In the case of the transactional penalty**, Treas. Reg. ' 1.6662-6(b)(3), provides, with minor modification, that the transactional penalty will not be imposed on any portion of an underpayment with respect to which the requirements of Treas. Reg. ' 1.6664-4 are met. Treas. Reg. ' 1.6662-6(b)(3) also notes that a taxpayer that meets the standards set forth in paragraph (d) of that section will be treated as having met the reasonable cause and good faith exception requirements of Treas. Reg. ' 1.6664-4. As we will see, the paragraph (d) documentation requirements set forth a higher standard for reasonable cause. Exception for the Net Adjustment Penalty

**In the case of a net adjustment penalty**, there is a specific rule to exclude certain amounts for purposes of determining the threshold requirements (and amount subject to the net adjustment penalty) under I.R.C. ' 6662(e)(3)(B). These rules require that the taxpayer maintains contemporaneous documentation to show adherence and compliance with the arms length standard. The rules differ depending on whether the taxpayer used a pricing methodology specified in the I.R.C. ' 482 regulations or an unspecified method. I.R.C. ' 6662(e)(3)(D) says that for purposes of applying the reasonable cause and good faith exception of I.R.C. ' 6664(c), the taxpayer must satisfy the requirements of I.R.C. ' 6662(e)(3)(B). Treas. Reg. ' 1.6662-6(c)(6) provides that a taxpayer will be treated as having reasonable cause under I.R.C. ' 6664(c) if the taxpayer meets the requirements of Treas. Reg. ' 1.6662-6(d), **the contemporaneous documentation requirements**.

### **Excluding Certain Adjustments from Penalty Computation**

When reasonable cause and good faith exception requirements are met with regard to specific adjustments made pursuant to I.R.C. ' 482, those amounts are not subject to a penalty. The threshold amounts must be satisfied by any adjustments that have not met the reasonable cause and good faith exception requirements. We could go back through CASES 1-11 and add facts that demonstrate that certain adjustments were, in fact, supported by contemporaneous transfer pricing documentation or other reasonable cause in the case of the transactional penalty.

*You might try going through the examples above to see which penalties would apply and at which rate if USCO were able to demonstrate reasonable cause and good faith as to certain adjustments.*

### **What are the contemporaneous transfer pricing documentation requirements?**

Treas. Reg. ' 1.6662-6(d) excludes an amount from the calculation of a net I.R.C. ' 482 adjustment if the requirements of paragraph (d) are met. Although paragraph (d) distinguishes between taxpayers using a specified I.R.C. ' 482 method, as opposed to an unspecified method, the documentation requirements are very similar. For purposes of this presentation, I will not differentiate between them. Treas. Reg. ' 1.6662-6(d) provides that a taxpayer must meet both the specified or unspecified method requirements and the documentation requirements.

### **The specified or unspecified method requirements:**

Generally, a taxpayer will satisfy the specified or unspecified method requirements if the taxpayer selects and applies a method in a reasonable manner. A method is considered reasonable if, given the available data, the taxpayer concluded that the method provided the most reliable measure of an arm's length result under the principles of the best method rule in Treas. Reg. ' 1.482-1(c). Whether the taxpayer's conclusion was reasonable must be determined from all facts and circumstances. The factors relevant to this determination are listed in Treas. Reg. ' 1.6662-6(d)(2)(ii)(A)-(G): The specified or unspecified method requirements:(A) experience and knowledge of taxpayer(B) extent to which reliable data was available(C) extent to which taxpayer followed the regulations under I.R.C. ' 482 (D) extent to which taxpayer relied on a professional study or other analysis(E) taxpayer's use of the arm's length range(F) extent to which taxpayer relied on APA methodology or other method specifically agreed to by the IRS(G) the relative size of the net transfer pricing adjustment in relation to the underlying transaction or transactions.

### **Contemporaneous Transfer Pricing Documentation Requirements:**

The contemporaneous transfer pricing documentation requirements are described in Treas. Reg. 1.6662-6(d)(2)(iii). The documentation is divided into the principal documents and the background documents. Generally, the documentation should tell the Service the Who, What, When, Where, Why and How of the intercompany transactions. Good documentation demonstrates a reasonable method reasonably applied. The Principal Documents

**The principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. The documentation must include the following 10 items:**

1. Overview of the business
2. Description of the organizational structure of all related parties engaged in transactions potentially relevant under I.R.C. ' 482 The Principal Documents
3. Documentation explicitly required by the regulations under I.R.C. ' 482 this item may include market share strategies under Treas. Reg. ' 1.482-1(d)(4)(i)unspecified transfer pricing methods under Treas. Reg. ' ' 1.482-3(e) and 1.482-4(d)profit split methods under Treas. Reg. ' 1.482-6cost sharing agreements under Treas. Reg. ' 1.482-7exceptions to adjustments for transfers of intangibles and lump sum payments under Treas. Reg. ' 1.482-4(f)(5)
4. Description of the transfer pricing method selected and explanation of why it was selected
5. Description of the methods that were considered and explanation of why they were not selected

### **The Principal Documents**

6. Description of the controlled transactions
7. Description of the comparables that were used
8. Explanation of the economic analysis and projections relied upon in developing the method
9. Description of any relevant data that as obtained after the end of the tax year and before filing a tax return, and which would help determine if a specified method was selected and applied in a reasonable manner
10. Index of the principal and background documents and a description of the record keeping system used for cataloging and accessing those documents. The Background Documents

The assumptions, conclusions, and positions contained in the principal documents ordinarily will be based on, and supported by, additional background documents. Documents that support the principal documents may include the documents listed in Treas. Reg. ' 1.6032A-3(c). Other documents may also be necessary.

The background documents are analogous to all the research and primary sources necessary to construct the items listed within the principal documents, which is analogous to an executive summary of the amalgamated research and information.

### **The Background Documents**

Some Service personnel have noted that it is unlikely that you can determine the reasonableness of any method selected and applied by the taxpayer without diligently checking the background



documents to see if the underlying analysis is reasonable.

**When does the documentation have to exist in order for it to be contemporaneous?**

Documentation, with the exception of the indices (principal documentation item 10) must be in existence when the income tax return for that tax year is filed.

**How do you get the documentation?**

**Ask.** The taxpayer must provide the documentation within 30 days of request. Be careful to word the request so that it included principal and supporting background documentation. In the case of background documentation, which may be overwhelmingly voluminous, the taxpayer may provide you the location and access to the area where the documentation is kept.

If the documentation is not provided within 30 days, it may not satisfy the reasonable cause and good faith exception requirements depending upon the length of and reason for the delay.

**Does a taxpayer have to prepare contemporaneous transfer pricing documentation?**

There is no obligation to prepare contemporaneous transfer pricing documentation described in Treas. Reg. ' 1.6662-6(d) and there is no penalty for not producing the documentation.

**You're kidding, right?**

**No. Does a taxpayer have to prepare contemporaneous transfer pricing documentation?**

Producing the documentation is a voluntary decision made by the taxpayer. The regulations serve to encourage taxpayers to prepare contemporaneous transfer pricing documentation through the use of the penalty. Taxpayers are free to produce or not produce documentation based upon their risk-based assessment or cost/benefit analysis. We can also say that the quality of any contemporaneous transfer pricing documentation that is produced is a risk-based assessment.

**What is contemporaneous transfer pricing documentation used for?**

It encourages taxpayers to analyze intercompany pricing at the time of the transaction or relatively proximate to the transaction.

It provides the audit team with the taxpayer's position up front, at the beginning of the audit cycle.

It provides the audit team with a Road map to organize their exam resources.

Taxpayers rely on their contemporaneous transfer pricing documentation defensively during the audit process to demonstrate that the taxpayer complied with the arm's length standard under I.R.C. ' 482. It provides the basis for the reasonable cause and good faith exception to the penalty if the requirements are met.

### **How do you analyze the contemporaneous transfer pricing documentation?**

Remember, the point of the documentation requirements is to demonstrate a reasonable method reasonably applied. The taxpayer may have the wrong answer, but it must be a well-reasoned wrong answer based upon factual and economic support.

Analyzing the documentation means examining the information provided to see if the information is consistent with the I.R.C. ' 482 regulations.

### **Who makes the decision to apply the penalties under I.R.C. ' 6662(e)?**

This is a touchy subject. Remember, whenever the penalty thresholds are met, the penalty will apply absent a showing of reasonable cause and good faith.

For purposes of consistency and reporting, the Service established the Transfer Pricing Penalty Oversight Committee to review every proposed assertion of the I.R.C. ' 6662(e) penalties.

### **Who makes the decision to apply the penalties under I.R.C. ' 6662(e)?**

It is my view that in every case where the numeric thresholds are met, the Oversight Committee should review the proposed penalty to review any reasonable cause and good faith efforts the taxpayer has made with regard to the transfer pricing adjustments.

Although the Oversight Committee's review is not binding upon the Exam team that submits the proposed penalty, the Oversight Committee is able to provide consistent guidance regarding whether the reasonable cause and good faith exception requirements are satisfied.

### **Are there other ways by which the penalty can be avoided?**

Absent a showing of reasonable cause and good faith as defined in I.R.C. ' ' 6662(e) and

6664(c), there are no other mechanisms to exclude I.R.C. ' 482-based adjustments from the penalties, assuming the other thresholds are met. This is not a discretion-based penalty. Especially with regard to the net adjustment penalty, the criteria to qualify for the reasonable cause and good faith exception are objective.

**Are there other ways by which the penalty can be avoided?**

This is both a blessing and a burden. It is a blessing because the Service is able to assert the I.R.C. ' 6662(e) penalty without looking wantonly punitive, as the penalty is fairly mechanical and flows from the underlying I.R.C. ' 482 adjustment. On the other hand, it is a burden to the Service, because penalties are often considered a bargaining chip by which settlements may be reached. Absent contemporaneous transfer pricing documentation, a taxpayer may have more reason than ever to fight an I.R.C. ' 482 adjustment when there is a 40% gross valuation misstatement looming over them.

**Questions?**

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