Tax accounting services:
The impact of transfer pricing in financial reporting
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Tax accounting services

Transfer pricing generally refers to the method of determining the price of goods, intangibles, and services in transactions between commonly controlled companies. Transfer pricing can be important for a variety of business reasons, including assurance of minority investor or creditor interests in corporate subsidiaries. The income tax consequences of transfer pricing are typically most pronounced when the parties to the transactions are taxed in different jurisdictions. In effect, transfer pricing determines how much income or loss from related-party transactions is subject to each jurisdiction’s tax. Transfer pricing applies to most intercompany transactions, including sales of tangible property, sales or licenses of intangible property, services, leases, and financing arrangements.

The determination of an appropriate transfer price is generally predicated on what is known as the “arm’s length” standard. That standard tests what would have occurred in a comparable transaction between unrelated parties. The pricing calculation is often multifaceted, taking into account economics, finance, industry practices, and functional analysis. If the taxing authority considers another price more reasonable, it may adjust the reported taxable income or loss. Interest and penalties could also apply, depending upon the jurisdiction’s laws and practices. Such an adjustment may, in turn, give rise to a corresponding and offsetting adjustment in another taxing jurisdiction where an affiliate resides.

With the continued globalization of business and growth in foreign income, taxing authorities have increased their focus on transfer pricing. Many, including the Internal Revenue Service, have publicly renewed their emphasis on transfer pricing matters in examinations and begun to focus on global information-sharing strategies. Increased attention is also being given to “competent authority” cases, where resolution is based on inter-governmental negotiation regarding the appropriate arm’s length pricing in the particular case, under the authority of an income tax treaty between the jurisdictions.

In response to the increasing scrutiny and worldwide information sharing, more multinational companies are entering into advance pricing agreements (APAs) with taxing authorities. APAs represent an agreed-upon transfer pricing methodology, generally based on a predetermined financial metric such as operating margin. APAs in some cases are unilateral (with one taxing authority) and in other cases bilateral or multilateral (whereby coordinated agreements are obtained between the two or more relevant taxing authorities). Agreements typically cover multiple annual periods.

The topic of transfer pricing in relation to financial reporting is often associated with uncertain tax positions — that is, the extent to which tax reserves may need to be recorded due to uncertainty with respect to tax return positions. However, transfer pricing can also have other important financial reporting implications. This publication serves to highlight several important areas of financial reporting that can be affected by transfer pricing.
1. Uncertain tax positions

Under US GAAP, Accounting Standards Codification 740, Income Taxes (ASC 740), provides guidance for recognizing and measuring positions taken or expected to be taken in a tax return that directly or indirectly affect amounts reported in a company's financial statements. The guidance provides a two-step model: Step 1 – A tax benefit is recognized only if it is more likely than not sustainable based upon its technical merits; and Step 2 – The tax benefit recognized is measured as the greatest amount that is more than 50% likely to be realized upon settlement with the taxing authority. Amounts unrecognized are typically known as tax reserves.

The application of this accounting model requires significant judgment and is dependent upon the facts and circumstances. In some cases, tax positions arising from intercompany transactions may require assessment to determine whether the recognition threshold (Step 1) is met. For example, uncertainty may exist regarding the characterization of an intercompany arrangement as debt versus equity under the income tax laws. Most transfer pricing positions, however, are considered to meet the recognition threshold; the uncertainty relates to the transaction's valuation or pricing, which is addressed in the measurement process (Step 2). Determining the appropriate valuation or transfer price often leaves uncertainty. A transfer pricing analysis may produce a range of appropriate outcomes, yet the measurement process requires a company to determine which single outcome represents the greatest amount that is more than 50% likely to be accepted by the taxing authority.

The assessment of transfer pricing uncertainty should include consideration of the relevant tax laws, tax treaties, and any arrangements established with taxing authorities. APAs may help mitigate or alleviate a company's risk that its transfer pricing arrangement will be subject to challenge. Even when transfer pricing falls within an arm's length range that is properly documented by the taxpayer, it may be appropriate for a company to record a reserve in its financial statements. This may occur when a company expects it will ultimately settle with the taxing authority at some other amount. In measuring the reserve to record, companies may need to consider the results of alternative transfer pricing methods in their analysis.

Once all relevant information is identified and assessed, consideration should be given to the impact an uncertain transfer pricing position may have in other tax jurisdictions. An uncertain position taken in one jurisdiction may give rise to a corresponding tax position reducing taxable income in another jurisdiction where an affiliate resides. ASC 740 prohibits the offsetting or netting of a reserve in one jurisdiction against a potential tax overpayment (or receivable) in a separate jurisdiction. Companies should assess and record both the income tax liability and any potential asset separately (on a gross basis) in the financial statements. In some instances, the recording of an uncertain tax position may impact the amount of other taxes due. Taxes that are not based upon income, such as VAT or customs duties, and related uncertainties, should be accounted for outside of ASC 740.

When a company is under examination by a taxing authority, the status of the exam must be monitored continually to assess potential financial reporting changes. To the extent new information arises, a company must consider whether there should be a remeasurement of benefits. Reserves for positions taken in tax years that are not examined, and any corresponding assets recorded for other jurisdictions, would be reversed when the relevant statute of limitations expires.
An inherent assumption within the financial accounting model for income taxes is that the reported amounts of assets and liabilities reflected in a company's financial statements will ultimately be recovered or settled. Based on that assumption, the difference between the book and tax basis of assets and liabilities will result in either deductible or taxable amounts in future years. These are known as temporary differences, whose consequences are recorded as deferred tax assets or liabilities. Tax attributes, such as loss or credit carryforwards, are also recorded as deferred tax assets.

ASC 740-10-30 requires companies to weigh all available evidence to determine whether all or some portion of deferred tax assets will be realized, and establish a valuation allowance when it is more likely than not that the assets will not be realized. Evidence to be considered with respect to each tax jurisdiction includes historical information supplemented by information about future taxable income that is currently available. Forming a conclusion that a valuation allowance is not needed can prove challenging when there is negative evidence such as cumulative losses in recent years. For deferred tax assets in a jurisdiction in which significant revenues or costs arise from intercompany transactions, transfer pricing can be a key focal point.

The need for a valuation allowance may be overcome by the existence of sufficient future taxable income, which can be directly affected by transfer pricing arrangements. For example, a company may have flexibility to adjust its existing transfer pricing and allocate a greater percentage of profit to a jurisdiction with recent losses and deferred tax assets. Provided the adjusted transfer price continues to fall within the arm’s length range and is economically prudent, the change may constitute objective positive evidence supporting realization of a company’s deferred tax assets. For companies that have APAs, the evidence may be strengthened by what is effectively third-party (taxing authority) verification.

Another source of taxable income for companies to consider when evaluating the realizability of deferred tax assets is tax reserves. For multinational companies with reserves for transfer pricing uncertainties, consideration should be given to whether settlement of the reserves would constitute a source of taxable income. That may depend on the period(s) in which additional taxable income would be reported in the relevant tax jurisdiction.
3. Measuring deferred taxes on foreign earnings

ASC 740-30-25-3 presumes that the undistributed earnings of a foreign subsidiary will ultimately be repatriated to the parent company. Under this general presumption, companies based in jurisdictions that apply a worldwide system of taxation (such as the United States) would record a home country deferred tax liability on the “outside basis” difference in a foreign subsidiary. The outside basis difference represents the difference between a parent’s book and tax basis in a subsidiary, often including undistributed foreign earnings, currency translation, and other accounting adjustments. An exception, if met, allows a company to overcome the presumption that foreign earnings will be repatriated and forgo the recording of a tax liability for some or all of the outside basis difference.

For companies that intend to repatriate foreign earnings and therefore record a deferred tax liability on the outside basis difference, consideration should be given to the impact of transfer pricing on the deferred tax calculation. (For companies not recording a deferred tax liability, transfer pricing can impact the estimate of the unrecorded tax that may be disclosed.) Transfer pricing will affect, for example, the amount of foreign taxes due in a given jurisdiction and the respective foreign tax credit that would arise upon repatriation. This might include foreign tax reserves recorded as a result of transfer pricing uncertainty. Transfer pricing can also affect the amount of taxable income that will result upon repatriation, as well as from categories of income that are ineligible for home country deferral (such as “Subpart F income” under US tax law).

The computation of a company’s outside basis difference also includes book-tax differences associated with stock-based compensation. It is common for US-based multinationals to issue stock-based compensation to the employees of subsidiaries, both domestic and foreign. Generally, stock-based compensation awarded to employees of foreign subsidiaries does not give rise to a tax deduction in the United States. Consideration should be given to whether a parent and foreign subsidiary’s transfer pricing arrangements include the sharing of costs associated with stock-based compensation awards. If so, it may in effect give rise to an additional tax benefit in the United States. Consideration should be given to whether a parent and foreign subsidiary’s transfer pricing arrangements include the sharing of costs associated with stock-based compensation awards. If so, it may in effect give rise to an additional tax benefit in the United States. In some circumstances, stock-based compensation awards can also reduce the outside basis difference, and thereby the measurement of the deferred tax liability.

Transfer pricing can also affect the amount of taxable income that will result upon repatriation, as well as from categories of income that are ineligible for home country deferral.
4. Business restructurings

Multinational companies often undertake internal restructurings of their business operations. This can involve cross-border redeployment of assets, risks, and functions, all of which implicate transfer pricing. Common forms of restructurings result in limited risk and “cost-plus” transfer pricing arrangements. Another common restructuring involves the regionalization or centralization of IP, which may require a company to migrate all or a portion of its IP between jurisdictions. The accounting impact of restructurings can include tax consequences in both the transferring and receiving jurisdictions.

Under US GAAP, the income tax effects resulting from intercompany transfers of assets are generally not recognized immediately in the consolidated financial statements. Specifically, Consolidation subtopic ASC 810-10-45-8 defers taxes paid on intercompany profits on assets remaining within the consolidated group, and ASC 740-10-25-3(e) prohibits the recognition of a deferred tax asset for basis differences related to the intercompany profits. (Note: This deferral principle does not apply under IFRS.) If the arrangement constitutes the transfer of an asset, any net income tax consequences of the transfer are generally deferred and amortized to income over the period of economic benefit.

In the context of a migration of IP, consideration should be given to whether the tax consequences fall within the scope of this deferral principle. While an exclusive license for the entire economic life of IP may indicate that an asset has been transferred, the determination is often judgmental and dependent upon the facts and circumstances. Companies should review the arrangement to determine whether it confers ownership rights and burdens and whether the benefits and risks associated with the IP have been fully transferred. The determination should be aligned with the company’s transfer pricing analysis.

Companies should take care in determining the extent to which the deferral applies — for example, whether the deferral would apply to any “exit taxes.” An exit tax may be imposed based on the value of assets deemed transferred to a different tax jurisdiction, or perhaps on the value of forgone future profits. The deferral principle would apply only to an exit tax that is considered a tax based on income. The deferral may apply to uncertain income tax positions, such as uncertainty relating to the value assigned to IP. For companies not asserting indefinite reinvestment, the deferral may apply to a resulting remeasurement of the deferred tax liability.

Internal restructurings may involve a change in tax status for one or more of the entities involved, such as from non-taxable to taxable or vice versa. ASC 740 requires the tax effects of a change in tax status to be included in income from continuing operations at the date the change occurs. The deferral principle discussed above would not apply to these tax effects. A change in tax status is considered to occur on the date when approval is obtained for elective changes or the date the filing or election is made if approval is not required.
5. Separate company financial statements

Businesses that prepare consolidated (or group) financial statements also often prepare separate financial statements for one or more subsidiaries or other business units. The preparation of separate company financial statements may arise from internal business needs, but often serves to meet the external requirements of regulators, investors, and creditors.

Intercompany transactions that were eliminated in the consolidated financial statements must often be reported in separate financials and adequately disclosed to ensure readers have decision-useful information. When related-party transactions represent a significant part of recurring operations between the separate reporting members and affiliates in the broader reporting group, a transfer pricing analysis could be a relevant factor to consider with respect to the measurements of pre-tax revenues or costs from those transactions.

The measurement of revenues and costs would be assessed for reasonableness and consistency with a company’s transfer pricing methodologies. This may extend to intercompany transactions that are reported in a consolidated tax return with members of the broader reporting group. If transfer pricing methodologies were not previously established, an appropriate analysis may be warranted to support the separate company statements. Terms set forth in APAs would represent third-party evidence to be considered in measuring pre-tax revenues and costs. The respective income tax accounting would be applied based on the measurements recorded in the standalone pre-tax accounts.

Consideration should also be given to tax reserves and settlements with taxing authorities relating to transfer pricing. For companies with APAs, reserves may need to be considered in separate company statements when the business results fall outside the range of the agreed-upon financial metric. Tax reserves or settlements may give rise to an expectation (or agreement) with the related party to make a compensating payment or pricing adjustment. Whether such payments or adjustments are recorded in equity or the income statement will depend upon the facts and circumstances.

If transfer pricing methodologies were not previously established, an appropriate analysis may be warranted to support the separate company statements.
6. Other considerations

Interim reporting
The calculation of a company’s estimated annual effective tax rate (AETR) should reflect a company’s transfer pricing policies. Specifically, the calculation should include related-party transactions in the annual projections of pre-tax earnings, and the appropriate jurisdictional tax rates applicable to those transactions. For example, intercompany sales revenue should be allocated to the appropriate tax jurisdictions (e.g., foreign, domestic, state, and local) in accordance with a company’s transfer pricing arrangements, and the appropriate tax rates and apportionment percentages applied. Any required tax reserves relating to current-year transactions should be included in the AETR calculation. Throughout the course of the year, as the intercompany transactions change in volume or shift across jurisdictions, companies should update their AETR estimates accordingly.

Mergers and acquisitions
When determining the appropriate book and tax values of assets acquired and liabilities assumed in a business combination, transfer pricing may play an important role. For example, in a taxable acquisition (wherein tax bases are adjusted to the purchase price), the tax valuations are prepared on a legal entity or tax-jurisdictional basis. Transfer pricing should be embedded within the tax valuations even though it may be less relevant to financial reporting valuations performed on a consolidated or reporting unit level. In addition, for tax and book purposes, an economic analysis is often used in determining an asset’s fair value based on the expected level of income (discounted cash flows) to be generated by that asset. The tax cash flows relating to an asset can depend upon the tax jurisdictions and respective tax rates applied to intercompany transactions involving the asset. Transfer pricing should also be considered in measuring deferred taxes recorded in acquisition accounting, assessing the need for a valuation allowance, and recording any required tax reserves.

Disclosures
Companies should consider the impact that transfer pricing may have on accounting estimates and assertions that may warrant disclosure in the financial statements. Income tax footnote disclosures might include a discussion of a transfer pricing strategy that serves as objective positive evidence in support of the realization of a company’s deferred tax assets. Increases and decreases in the tabular reconciliation of unrecognized tax benefits related to transfer pricing uncertainties should be reported exclusive of corresponding benefits in other jurisdictions. Early warning disclosure may be warranted for possible near-term changes in uncertain transfer pricing positions.

SEC registrants are required to discuss their current financial condition and expected changes in Management’s Discussion & Analysis of Financial Condition and Results of Operations (MD&A). Consideration should be given to the impact of transfer pricing in these discussions. That may include, for example, risks and uncertainties associated with transfer pricing policies that could impact liquidity or capital resources. Potentially significant consequences of legislative or regulatory proposals may be discussed. In some circumstances, material terms of APAs may warrant disclosure.
Transfer pricing arrangements and analysis play a significant and diverse role in financial reporting. The impact of transfer pricing spans multiple areas, from business restructurings to valuation allowances. Transfer pricing can also have unique relevance in separate company financial statements and in acquisition accounting. When preparing financial statements and disclosures, attention should be given to the cause-and-effect relationship of transfer pricing to both pre-tax and income tax accounts. Cross-functional coordination is crucial to ensuring that all significant financial reporting implications have been addressed.

Conclusion

When preparing financial statements and disclosures, attention should be given to the cause-and-effect relationship of transfer pricing to both pre-tax and income tax accounts.
The article is intended not just to inform but to raise questions. PwC is committed to helping companies navigate today’s tax accounting issues. For more information, please reach out to your local PwC partner and/or the primary authors.

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