

Transfer pricing: the global issue that hits home*

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Transfer pricing isn't a new area, but it's relevant now more than ever—companies are on the move around the globe, and tax authorities across state and international borders are imposing new documentation requirements, assessing stricter tax penalties and increasing information exchange and audit activity.

Intercompany pricing strategies affect the bottom line in ways you might not expect

When related parties are in different countries or states, tax authorities want to ensure that profits won't be artificially shifted from a higher-tax jurisdiction to a lower one. Businesses also have an interest in ensuring that profits clearly reflect the division of functions, risks and assets employed between the parties. However, many companies consider transfer pricing (TP)—how a business prices intercompany transactions—to be too costly a burden, to simply avoid potential tax compliance penalties. They also frequently think of transfer pricing as only relating to pricing for goods and services.

But TP goes beyond the pricing of goods and services, and effective TP policies provide multiple benefits that go beyond penalty avoidance. "An effective transfer pricing policy is a strategic tool," says Bill Seeger, a transfer pricing principal with PricewaterhouseCoopers in Dallas, "not a tax compliance item. It's really about using business acumen and about determining how to use effective pricing and planning to save money."

What is transfer pricing?

Transfer pricing is a term used to describe all aspects of intercompany pricing arrangements between related business entities. Seeger points out, "Transfer pricing is not just about the transfer or sale of tangible property. It also applies to services, leasing, loans and loan guarantees, other financing transactions, and transfers of intellectual property. Transfer pricing applies to any intercompany transaction between different tax jurisdictions, whether across state or international borders." TP applies to both domestic and international related-party transactions, and is designed to prevent tax avoidance among related entities due to differences in rules and rates between jurisdictions and to place parties under common control on parity with unrelated taxpayers.



a and b are related parties in different tax jurisdictions.

Differences between jurisdictional tax rules and rates create the opportunity for related entities to shift income from a higher tax jurisdiction to a lower tax jurisdiction. Tax authorities of course attempt to source as much taxable income as possible in their respective jurisdictions.

What is “arm’s length?”

The arm’s length principle is usually applied by comparing the “conditions” (e.g., price or margin) of a controlled transaction with those of independent transactions. Guidelines allow the use of inexact comparables that are “similar” to the controlled transaction but not the use of “unadjusted industry average returns.” Some factors to consider when assessing the comparability of a transaction include:

The specific characteristics of the property or services;

The functions that each enterprise performs, including the assets used and, most importantly, the risks undertaken;

The contractual terms;

The economic circumstances of different markets (for example, different countries, wholesale versus retail); and

Business strategies (for example, market penetration schemes when a price is temporarily lowered).

In the US and most other developed countries, a proper transfer price for a transaction is one that two independent parties, dealing “at arm’s length,” would agree upon. The resulting price is called an “arm’s length price” and the arm’s length principle is a cornerstone of the TP methodology used in most countries.

Setting transfer prices may seem simple in theory but can be complex in practice, since it can be difficult to obtain sufficient information to apply the arm’s length principle as defined by tax law.

In the US, TP tax rules are governed by Internal Revenue Code section 482, which gives the IRS the right to reallocate certain income and expenses between related parties doing business in different jurisdictions. In 1968, the IRS issued regulations that provided rules for applying the arm’s length standard. However, new temporary and proposed regulations were issued in 2006 that change the rules substantially in the area of intercompany pricing for services and intangibles. The changes apply to a wide range of activities. Seeger notes that “businesses are now required to charge for such activities as management services, back-office services, marketing and selling services, supervisory expenses and R&D services. There are also new rules requiring pricing for intangibles.”

In addition, the IRS is tightening up the cost-sharing regulations. “Companies were moving economic rights income from intangible property offshore, to low-tax jurisdictions, and selling from there—and the tax dollars were not coming back to the US,” says Seeger. “Midsize companies that have entered into a cost-sharing arrangement should look closely at these temporary and proposed regulations as they are modified.”

The sleeping tigers are awake

Revenue authorities have, in general, become much more aggressive in the TP arena over the last few years, and there has been an increase in both the number and intensity of transfer pricing audits in the US and abroad. “We are also seeing penalties being assessed more frequently, and the complexity of the issues and arguments has also generally increased,” says Seeger.

The IRS is looking more deeply at intercompany pricing issues. For example, an IRS directive issued in 2003 requires agents to request contemporaneous TP documentation (i.e., documentation prepared at or near the time the transactions take place) from multinationals and to perform more than a cursory review of these reports. As a result, multinational entities should expect to be asked for adequate documentation on how they set their intercompany prices and why the result is arm’s length, as part of the standard review of their US tax returns.

In addition, the IRS now has extensive resources available for field audits, at the appellate level, and in competent authority procedures, including agents specially trained in economic analysis. Transfer pricing audits are not limited to cases where avoidance is suspected.

States are also taking a harder look at TP issues for companies with operations that cross state boundaries within the US. One point of focus for the states has been interstate intellectual property issues, and, in recent years, several states have enacted legislation disallowing expenses for various intercompany intangible property transactions, including technology royalties, trademarks, trade secrets, and other expenses relating to intangible property.

In addition, in many states, management service fees payable to a related party have become disallowed expenses to the extent that they involve any embedded intangible assets or nonroutine services where it is difficult to benchmark the market value.

FASB Interpretation No. 48 (FIN 48) also has an impact. Seeger points out that “along with increased scrutiny by the IRS is a mandatory deeper look at transfer pricing structures for FIN 48 purposes. Businesses must have adequate documentation to support the position that no reserve is required for FIN 48 purposes, and now auditors are required to review transfer pricing documentation for FIN 48 reserves.”

The problem of penalties

A major and growing problem for the executives of multinational companies is the issue of preparing documentation to demonstrate compliance with TP rules, both in the US and abroad.

In the US, the section 482 regulations provide wide and strict rules for documentation of TP policies. Taxpayers can no longer avoid documenting the arm’s length character of their TP. If they do, they run the risk of substantial penalties. “The IRS is now applying penalties that have statutorily existed for a long time,” explains Seeger. “In the past, agents failed to impose them with any sort of consistency. Now, if an agent is not assessing penalties when appropriate, they must internally justify why. Companies must now have adequate documentation.”

What does proper documentation look like?

Most countries’ transfer pricing documentation requirements vary to some extent. However, as a general guide, a defensible transfer pricing policy requires documentation in the following areas in order to demonstrate how the policy complies with the arm’s length principle:

A description of the transfer pricing policy;

Guidelines interpreting the policy;

Inter-company legal agreements;

Functional analysis of the entities involved;

Comparables supporting the policy;

Financial analyses; and

Industry evidence required to substantiate the decisions made.

The US is not the only country taking action. More and more countries have established—and are now enforcing—documentation rules for TP policies. This is a particular challenge, since each country typically expects something slightly different in the way of documentation.

Going global—transfer pricing often catches private companies by surprise

A company should establish a defensible TP policy when it first begins to carry on part of its business on a cross-border basis. Any more limited objective inevitably gives rise to later difficulties.

“Ironically, some of the most complex transfer pricing issues I’ve tackled have been with private companies,” says Seeger. There are a number of reasons why, though many problems are the outcome of inadequate attention to TP when a company first begins to go global. He points out, “For example, pricing policies may not have been adequately thought through... they may be set on-the-fly or based on inconsistent criteria, or company leaders may erroneously think mid-size or private companies are exempt. Or, at the beginning, intercompany transactions may be small and the business may be hesitant to invest the necessary effort in establishing the policy. Or, when people hear ‘documentation,’ they think it has something to do with filing tax returns.”

Seeger adds, “Regardless of the reasons, what begins on a weak foundation grows into a larger, weaker framework, and an IRS audit is often the wake-up call. Unfortunately, at that point, a company not only faces penalties, but also potentially large costs to disentangle the pricing arrangements, figure out what should be done, and implement appropriate and effective transfer pricing policies.”

In addition, TP policies are not purely about taxation. For example, unless properly addressed, TP policies can affect management behavior where managers are remunerated by a bonus linked to local company operating profits. Another area often overlooked is the effect of transfer prices on indirect taxes. For instance, the movement of goods across international borders often gives rise to a customs duty liability. These effects must be considered as part of an effective TP strategy.

An ongoing process

Putting in place a well thought-out TP policy up front is essential, but an effective process isn’t a one-time event. To maintain its value, the policy must be reviewed on an ongoing basis. For example, an initial TP policy may not reduce the effective worldwide tax rate. Apart from the difficulty in devoting sufficient resources to pricing and planning when developing new markets, it’s difficult to predict accurately how the overseas operations will progress in terms of sales and expenses.

Many different events may require re-thinking of a TP policy, for example:

- A change in business operations or risks, including exchange risk
- A change in the operating structure of a company
- Parent company desires or pressure
- Changes in law

The sometimes-hidden benefits of planning

Appropriate TP policies and documentation are necessary to meet compliance requirements and avoid penalties, but “transfer pricing has more than a compliance objective,” says Seeger. “Companies need to ask: ‘how can we use it to benefit the position of the company?’ ” A transfer pricing analysis cannot only reduce taxation and avoid penalties—it can also help a company identify which activities are (or are not) performing well—and can uncover pricing policies that are inadequate for financial purposes.

For example, a company that is incurring losses in the US may discover that it is not charging royalties for intellectual property, or it may discover that the US is providing administrative services to related parties in other countries without charging out the costs. Seeger points out, “Clients sometimes ask, ‘can we use transfer pricing to get cash into the US?’ The answer is yes, if current transfer pricing policies are not correct. The regulations allow you to make adjustments,” says Seeger, “as long as there is an arm’s-length result. For instance, a client who was seeking to bring cash back to the US discovered that its transfer pricing prices were too low. Transfer prices were raised so that an appropriate amount of revenue was earned. In addition, they had millions of dollars of central administration costs that had not been adequately allocated abroad.”

Another example of a planning opportunity is one that can arise as a company’s R&D activities move to different locations. “After a while, nobody knows who’s sharing what or with whom” says Seeger, “or, commercially viable R&D may be in a high-tax jurisdiction. There may be no coordinated R&D or intangible property policy. The TP rules allow companies to think about the most effective way to benefit from investment in R&D or marketing structures such as principal vs. agent, or licensee vs. licensor. A good transfer pricing policy will look at licensing options and legal and economic ownership arrangements.”

Seeger concludes, “Tax authorities will continue to develop more sophisticated related-party regulations and tighter enforcement mechanisms. The right amount of transfer pricing effort can pay off in the form of a more stable tax charge, coupled with the ability to defend a company in the event of a tax audit. “When businesses don’t take a good look at transfer pricing issues,” he says, “they leave money on the table. Appropriate transfer pricing can bring dollars to the bottom line.”

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Reduce the risks, increase the benefits

Risks of an inadequate transfer pricing process:

- Increased local tax liability
- Potential double taxation
- Penalties and interest for inadequate documentation

Benefits of a proactive TP process:

- A properly designed, implemented, and monitored process can:
 - Reduce the above-cited risks
 - Reduce a group’s worldwide tax burden
- Uncover opportunities for properly assigning profits and cash to meet business goals
- Keep pricing policies up to date with tax and other legal changes

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