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Transfer pricing: Leading documentation practices for multinationals

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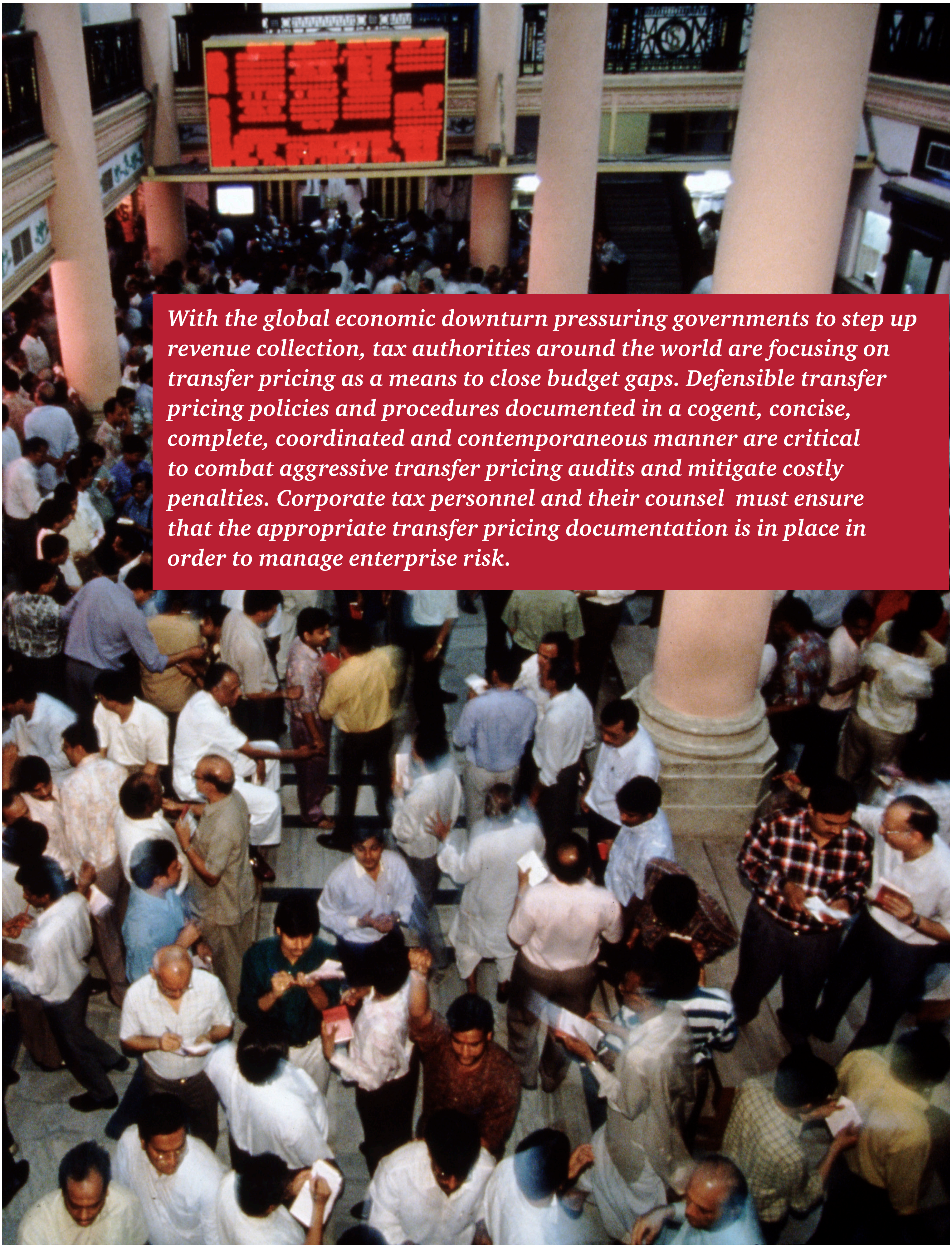

With the global economic downturn pressuring governments to step up revenue collection, tax authorities around the world are focusing on transfer pricing as a means to close budget gaps. Defensible transfer pricing policies and procedures documented in a cogent, concise, complete, coordinated and contemporaneous manner are critical to combat aggressive transfer pricing audits and mitigate costly penalties. Corporate tax personnel and their counsel must ensure that the appropriate transfer pricing documentation is in place in order to manage enterprise risk.

Summary

Nearly 100 countries around the world have rules governing transfer pricing and nearly all require documentation either to be submitted or in place at the time the tax return is filed or when requested by the tax authority. The US requires contemporaneous documentation—as described in Treas. Reg. section 1.6662-6(d)(2)(iii)—to be in place at the time the return is filed in order to obtain penalty protection. Transfer pricing adjustments continue to be a key focus of the Internal Revenue Service (IRS) and foreign tax authorities as they can result in large tax deficiencies. A proactive approach to analyzing and documenting intercompany transactions on an enterprise-wide basis is vital to managing transfer pricing audit risk for multinational companies. Leading practices dictate that transfer pricing policies and procedures be documented in a cogent, concise, complete, coordinated and contemporaneous manner in order to achieve more favorable outcomes in a controversy situation.

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Current landscape

As the global economic downturn continues to pressure governments around the world to boost revenue collection, more and more tax authorities are scrutinizing intercompany transfer pricing. The magnitude of related party transactions in the global marketplace combined with the belief on the part of many tax authorities that transactions between affiliates offer more opportunities for aggressive revenue allocation than the same transactions involving third parties has made transfer pricing a continued area of focus. Almost 100 countries around the world have rules in place governing intercompany transactions and nearly all require documentation in some form or fashion either at the time the tax return is filed or upon request by the relevant tax authority. In the US, contemporaneous documentation—as defined in Treas. Reg. section 1.6662-6(d)(2)(iii)—is required for penalty protection.

In his prepared remarks to the Tax Executives Institute's Midyear Meeting in April 2011, Michael Danilack, Deputy Commissioner LB&I for the US IRS, highlighted inbound companies—the US subsidiaries of foreign enterprises—as well as related party financing structures as particular areas of interest for IRS. He said, "We should be carefully evaluating the transactions of foreign-controlled US corporations and we should also be focusing on the US activities of foreign corporations in branch form … looking for situations in which the US base is being eroded through aggressive financing structures, misallocations of deductions, or transactions that avoid US tax when earnings are repatriated to the enterprise's home jurisdiction." Further, he noted that US-based multinationals are also a target with IRS needing "to focus more closely on the outbound activities of US-controlled entities where those activities are designed to maximize the rate effect of permanent reinvestment."

With transfer pricing facing heightened scrutiny in both the US and abroad, as well as the prevalence of complex cross-border intercompany financing structures, the need for defensible transfer pricing documentation has never been greater.

Documentation basics

Proposed by Congress in 1993, the US rules related to transfer pricing documentation are tied to the penalty provisions under Treas. Reg. section 1.6662-6(d). While technically the US does not require transfer pricing documentation as a matter of course, without it a taxpayer has no protection against penalties IRS may levy in the event a transfer pricing adjustment is sustained.

The US rules under Treas. Reg. section 1.6662-6(d)(2)(iii)(B) set forth ten principal categories of documents which are intended to accurately and completely describe the transfer pricing analysis undertaken by the taxpayer—from the representation of the facts and circumstances of the taxpayer and the relevant parties to the intercompany transactions through the selection and application of the best method. Typically, a report prepared by an external advisor will contain a substantial portion of the required principal documentation. Treas. Reg. section 1.6662-6(d)(2)(iii)(C) provides for taxpayers to collect and maintain background documents, as appropriate, which underlie and support the factual representations and economic findings and conclusions contained in the taxpayer's principal documents. Background documents may include intercompany invoices and other supporting information and records. The IRS may request principal documents or background documents at any time during an exam, and they must be provided within 30 days of the request.

On January 22, 2003, an LMSB (now LB&I) Commissioner Directive was set forth instructing field agents to issue a written request for principal transfer pricing documentation at the joint opening conference for each audit cycle. By rule, under US Internal Revenue Code section 6662(e), taxpayer must provide the documentation within 30 days of the request. In practice, this directive has led to requests for transfer pricing documentation from many companies who had deemed their related party transactions immaterial or for whom transfer pricing was not top of mind and, as such, had not prepared formal documentation. The result has been a last-minute scramble on the part of unprepared taxpayers consuming significant time, efforts, and resources.

As the US was the first country to promulgate specific transfer pricing documentation rules, its requirements are often reflected in the documentation protocols of other jurisdictions. Chapter V of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*—approved in their original version by the Organisation for Economic Co-operation and Development in 1995 and known as the OECD Guidelines—addresses the issue of documentation. Espousing that taxpayers make "reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the arm's length principle" (¶ 5.28), the OECD Guidelines provide general direction to taxpayers and tax authorities in terms of establishing documentation to both determine and evaluate the arm's length nature of transfer prices. Thus, taxpayers must familiarize themselves and comply with the specific requirements of the jurisdictions in which they operate which may require documentation to be in place at the time transfer pricing policies are set, at the time the tax return is filed—or as an attachment to the return in some cases—or within a specified period of time following a request from a tax authority.

Leading practices

Whether the taxpayer is preparing transfer pricing documentation for US purposes or those of another jurisdiction there are overarching leading practices which apply. Specifically, transfer pricing documentation should be cogent, concise, complete, coordinated and contemporaneous.

Cogent

Transfer pricing documentation should be relevant, compelling, and well-reasoned. The foundation of a sound transfer pricing analysis is a thorough and accurate representation of the facts and circumstances underlying the intercompany transactions under review. To be persuasive, the economic analysis and conclusions drawn from its results must flow directly from the functional profiles—in terms of activities performed, tangible and intangible assets employed, and risks borne—of the parties to the controlled transactions. A cogent presentation of the facts, analytical methodologies and their appropriate application, and the conclusions reached is vital to the success of the taxpayer's position.

Concise

Transfer pricing documentation should be succinct, well-organized, and to-the-point. Taxpayers should avoid introducing extraneous information about entities, transactions, jurisdictions, or other topics unrelated to the controlled transactions under review which distract from their central rationales. By the same token, concise documentation does not necessarily mean brief or short. As long as the information meaningfully advances the position of the taxpayer the colloquial expression that one does not bring a knife to a gun fight applies. Weighty documentation is not necessarily the enemy of a concise argument when it offers consequential supporting data.

Complete

Transfer pricing documentation should contain all components required by the jurisdiction for which it is prepared and address all relevant transactions. As multinational enterprises grow, their intercompany transactions inevitably become increasingly complex. Related party financing structures as well as transactions in which intellectual property is developed, sold, and/or licensed between members of the same controlled group are challenging to properly administer and document. Historically, taxpayers have thought of transfer pricing primarily in the context of tangible goods transactions. It is critical that all transactions—tangibles, intangibles, services, and financing—be identified and documented appropriately in accordance with the relevant rules and requirements. With respect to US taxpayers, the areas of imputed interest on intercompany trade receivables—as addressed in Treas. Reg. section 1.482-2(a)(1)(iii)(B)—and guarantee fees are often overlooked by taxpayers but not by IRS. Completeness in documenting transfer pricing is a key part of mitigating adjustment risk.

Coordinated

Transfer pricing documentation should present a consistent set of facts and analyses across jurisdictions and years and be in-line with tax filings including information returns such as the US Forms 5471 and 5472. At a minimum, transfer pricing is bilateral and—in many cases—multilateral. Thus, as many countries around the world—including the US—work to share taxpayer information and, in some cases, conduct joint audits with treaty partners, taxpayers must ensure that their transfer pricing documentation presents, characterizes, and evaluates the relevant intercompany transactions accurately and consistently across jurisdictions. A change in business facts and circumstances may necessitate a change in the transfer pricing method or approach for a given transaction. Taxpayers should be prepared to explain changes to methodology or approach which occur from one year to the next where there has been no change in the underlying facts and circumstances or relevant rules.

Contemporaneous

Transfer pricing documentation should use the best information available at the time transfer pricing policies are established and when the tax return is filed. While not a requirement in every jurisdiction, it is good practice for companies to proactively document their transfer pricing in real time to avoid last-minute crises in the event of an examination. After-the-fact documentation is also problematic in that recordkeeping systems may change over time and personnel turnover may result in a dearth of institutional memory regarding a particular transaction or period of time.

In practice

Multinational enterprises of all sizes and levels of complexity can benefit from well-executed transfer pricing documentation. As a practical matter, companies may best be advised to develop a unified framework—including a global functional analysis—which is then overlaid with country-specific documentation to address the on-the-ground requirements of the individual jurisdictions in which the company operates. This global core approach is both efficient and consistent in that it presents the facts globally while still catering to individual country needs.

Lastly, all taxpayers should remember that there is no such thing as an off-the-record e-communication. Counsel should admonish their clients that electronic correspondence—including e-mails, text messages, and instant messages—and other internal memoranda not a part of the formal transfer pricing documentation file are nonetheless readily discoverable by tax authorities.

Ultimately, understanding and applying leading practices in documenting intercompany transactions helps taxpayers and their counsel to better manage transfer pricing audit and adjustment risk.

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