Transfer pricing: Increasing importance to tax authorities and to businesses

What you need to know

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For management accounting and reporting purposes, a multinational company (MNC) has a certain amount of discretion in determining how to apportion expenses and returns to its subsidiaries in different countries. Subsidiaries may be accounted for as standalone businesses, or they may be integrated into larger business segments or geographies.

By contrast, national governments are interested only in statutory returns to the MNC's local entity. Because the profitability of a given MNC subsidiary will depend on the prices at which intercompany transactions take place, and because of the recent global recession, intercompany transactions are coming under increased scrutiny by governments around the world as they seek to maintain or increase their tax bases.

At the same time, MNCs understand that transfer pricing can impact shareholder wealth because it influences how taxable income is distributed among countries with various tax rates — impacting after-tax free cash flow.

It is therefore important that businesses with cross-border intercompany transactions understand the concept of transfer pricing, defined as the prices at which companies sell goods, services and intangible assets to related parties, as well as the global environment in which transfer pricing takes place, the requirements for compliance, and risks of non-compliance.

Transfer pricing: Increased global importance

Most countries apply some variation of the arm's length principle (ALP) in their transfer pricing regulations. The ALP requires MNCs to allocate income and expenses between parties as if the parties are unrelated and are acting in their own best interest. The ALP is articulated under the OECD Transfer Pricing Guidelines (OECD Guidelines) and in specific country regulations. The U.S. regulations related to transfer pricing are found in the U.S. Internal Revenue Code (IRC) Treas. Reg. § 1.482 (Regulations) and related sections.[2]

The U.S. experience exemplifies the increased focus on transfer pricing, which is paralleled in many other countries. The Internal Revenue Service (IRS) considers transfer pricing enforcement a key revenue generating area. In recent years, the IRS has hired more transfer pricing specialists and has hired more than 800 economists and international auditors. An IRS audit team is required to include an international auditor if certain tax forms are submitted that indicate international operations.[3]

The IRS, through the Transfer Pricing Compliance Directive, requires that Information Document Requests (IDRs) involving the company's transfer pricing documentation be issued at each audit's inception. These IDRs, commonly referred to as contemporaneous documentation requests, mandate that the taxpayer provide "any principal documentation outlined in Treas. Reg. § 1.6662-6(d)(2)(iii)(B) that has been prepared to support … transfer pricing methodologies for all years under examination." The documentation must have been in existence when the tax return was filed in order to provide protection from penalties.

Transfer pricing adjustments would likely increase an MNC's U.S. income and thus lead to additional taxes owed. This may cause double taxation if relief is not obtained in the other country. The IRS may impose non-deductible transfer pricing penalties of up to 40 percent of the tax owed (based on the size of the transfer pricing misstatement) plus interest.

While these issues in themselves can be daunting, the administrative burden associated with a transfer pricing audit can also be considerable. The transfer pricing audit of a middle-market company can result in numerous hours of lost productivity for the company and/or adviser costs that may exceed $100,000 for a single issue.

Other countries increasing scrutiny

The U.S. is not the only country increasing transfer pricing scrutiny. Certain mature tax authorities, such as Canada and the U.K., continue to vigorously enforce their transfer pricing regulations. Others, such as Mexico and Russia, are actively strengthening regulations. Mexico recently changed its position on certain long-standing maquiladora tax structures, making these structures less advantageous to MNCs doing business in Mexico. Russia recently enacted new detailed transfer pricing rules. Although generally consistent with the OECD Guidelines, these rules have been adapted to Russian realities and can be quite complex.

The increased focus is not limited to large economies. While still in its infancy, transfer pricing legislation is being drafted across the Middle East and North Africa. Egypt, Israel and Turkey are introducing the region's first fully implemented transfer pricing regimes. Other nations, including Algeria, Tunisia, Morocco and Qatar have introduced the ALP concept into their tax codes. Full rollout of transfer pricing regimes is anticipated in the above countries, and others in the region are expected to follow.

[1] For his contributions, the authors would like to thank Stephane Dupuis, a managing director of WTP Advisors, based in Montreal, Canada.

[2] Information related to penalties is found in IRC Section 6662.

[3] Specifically, Form 5471 or 5472.

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A conceptual framework for transfer pricing

The complexity of a given MNC's transfer pricing profile is fact specific. A more complex transfer pricing profile will entail multiple jurisdictions interacting in multiple transactions involving tangible products, intercompany services, intangible assets (such as the use of technology, patents, brands, know-how, etc.) and/or financing.

The first step in understanding an MNC's transfer pricing profile is to perform a functional analysis to identify each entity's functions, risks and ownership or use of intangible assets. Common functions are listed below (note that any given entity may perform multiple functions):

- Distribution
- Sales
- Manufacturing
- Services (e.g., R&D, marketing, back office support, etc.)
- Intangible property owners own, protect and defend a multinational's significant (non-routine) intangible assets.
- A principal is responsible for directing and managing the activities undertaken by the other entities. The principal makes strategic decisions, and bears the reward or penalty for the outcome of these decisions. The principal frequently owns intangible property.

After identifying each entity's primary activities, the MNC gathers financial data that identifies the value of the transaction flows and the return attributed to each participant. Depending on the specific transaction and the data, a transfer pricing method will be selected whereby the MNC's intercompany transaction is compared to the most relevant comparable benchmark data.

The selection of comparables is guided by the findings of the functional analysis. To the extent possible, comparables with functions, risks, asset bases and geographies (among other things) will be matched as closely as possible with those of intercompany transaction under review to provide the most reliable measure of an arm's length result. The example below demonstrates a simple case.

A closer look

Assume Company P, an MNC headquartered in the U.S., sells semi-finished widgets to its Canadian subsidiary, S. S further processes the widgets, and sells the final product to Canadian retail customers. A functional analysis determines that S's processing activities are minimal, and that it primarily functions as a distributor. While the widgets are sold under a brand, the brand is not widely recognized. P holds patents on the widget processing machines the Canadian subsidiary uses, and is responsible for strategic decisions.

S's cost of goods sold (COGS) amount is also the revenue earned by P on the transaction. This amount covers P's COGS and operating expenses required to process and ship the materials, plus profit to P in the form of a markup on P's total costs. Assume S earns revenue sufficient to realize an operating margin of 6 percent.

Regardless of how the MNC performs on a consolidated basis, the IRS will want to understand the pricing between P and S, the returns earned by each party, and how these returns compare to that of third parties engaged in similar transactions. The Regulations offer several ways to determine which methods and data can be used to determine arm's length pricing. In this example, we assume it is appropriate to determine a benchmark range of operating margins based on publicly available financial data for third-party companies that are comparable to S.

If the benchmark demonstrates that the interquartile range[4] (IQR) of a set of comparable companies' returns extends from 2 to 5 percent with a median of 3 percent, S's operating profits of 6 percent are above the IQR, and the IRS may impose a transfer pricing adjustment to the median of the range per the Regulations. The IRS infers that because the transaction was intercompany in nature, the Canadian subsidiary enjoyed returns higher than it would have been if earned by a third party performing the same functions in the same type of transaction. If the markup on COGS is adjusted upward, S's total COGS increases and P's revenue increases, and the IRS will collect taxes on the incremental income amount.

While this example is straightforward, in practice, transfer pricing issues can be complex. The ownership and use of intangible property is often a complicating factor; in the above example, if S's machinery used patented technology that was invented by S's engineers, or if the widgets were sold in Canada under a valuable brand owned by P, it would be necessary to understand whether appropriate returns were being paid for the ownership and use of intangible property.

If S developed the technology and know-how to process widgets, S may potentially merit returns higher than a routine distributor. If S sells products under brands owned by P, a separate licensing arrangement for Canadian use of the U.S. owned brand name may be required.

Minimize exposure

Every MNC has unique facts that dictate its transfer pricing opportunities and exposures. Prudent management will maintain awareness of the volume and nature of intercompany transactions, and the issues and requirements in each jurisdiction. Compliance requirements, and risks and potential costs of non-compliance, should be understood for each transacting country.

MNCs should identify jurisdictions in which they operate by level of risk, and focus their efforts on jurisdictions and types of transactions that fall under more scrutiny. Transfer pricing specialists can assist in reviewing current transfer pricing, implementing transfer pricing structures, and preparing documentation to minimize exposure to double taxation and non-deductible penalties. ■

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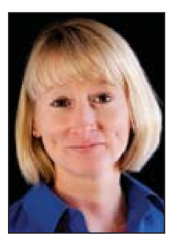

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[4] Treas. Reg. § 1.482-1 advocates using the IQR as a statistical technique to increase reliability of an arm's length range by eliminating outliers. The IQR is essentially the range between the smallest and largest values in the middle 50% of a comparable set. Note that the Canadian Revenue Authority often rejects the IQR as an appropriate technique to define an arm's length range.