Transfer Pricing in the Context of M&A

Being Proactive Pays Off

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After a lull following the “Great Recession” of 2008, mergers and acquisitions (“M&A”) have returned to prominence in today’s economy. M&A transactions are used by corporations to integrate vertically or horizontally, to achieve operational economies of scale, to broaden their funding base, to enter new geographic markets, to broaden their product offerings or to achieve cost and operational synergies. As with any significant business transformation event, transfer pricing implications likely will be associated with the M&A event in the form of both opportunities and risks.

An M&A transaction can offer corporations a unique opportunity to assess and integrate the legacy transfer pricing policies of the acquirer and the target. Each stage of the transaction, including the planning and due diligence stage, the mid-transaction stage and the post-integration stage, should include significant efforts to evaluate the transfer pricing strategy and risk profile of the combined enterprise, and to integrate transfer pricing into the operations and financial and management reporting systems of the combined enterprise. Failure to do so leaves the corporation at the risk of conflicting or inconsistent policies, inadequate or outdated transfer pricing documentation, and unnecessary tax and administrative costs. For the tax consulting professional or in-house tax professional, an M&A transaction presents opportunities and risks that should not be overlooked.

Transfer pricing plays an important role in many key operational aspects of a business, including R&D; procurement, manufacturing, distribution and other supply chain functions; as well as shared services, management services and other “head office” functions. Many of these aspects likely will be subject to integration efforts as part of the M&A transaction. Furthermore, as the combined enterprise integrates products and services and deploys intangible property (“IP”), transfer pricing considerations must be part of the IP integration efforts.

Transfer pricing must also be considered in the process of evaluating the projected cash flows of the combined enterprise. The application of the “arm’s length” principle to intercompany transactions is the norm under the tax laws of almost all developed economies, and many developing economies as well. For this reason, the projected operating results of the combined enterprise cannot present a realistic picture of the individual legal entities or operating units unless arm’s length pricing has first been “baked into” the results. Similarly, any discounted cash flow analysis of the combined enterprise must be based on cash flows that incorporate arm’s length transfer pricing. Finally, any redeployment or realignment of

IP within the legal entity structure of the combined enterprise, and the resulting projected operating results of the licensor and licensee operating units, should be based on arm's length transfer pricing.

Transfer pricing considerations can also influence the manner in which the M&A transaction is funded. This is particularly true in cases where debt financing will form a material part of that funding. Debt financing often involves the imposition of debt covenants on the combined enterprise, including covenants that are tied to cash flows that are generated by the combined enterprise or by individual operating units. As noted above, both the projected and actual cash flows generated by any particular operating unit within the enterprise must incorporate the arm's length transfer pricing standard. Failure to do so may result in unexpected pressure on the covenants down the road when "actual" calculations using arm's length transfer pricing amounts don't support the minimum debt covenant requirements.

M&A transactions provide the opportunity to integrate legacy transfer pricing policies of the acquirer and the target and the business case to create a new, consistent policy for the combined enterprise. In the course of this integration effort, corporations must consider the legacy tax audit experiences of each company, and in each material jurisdiction; any prior non-traditional transfer pricing mechanisms in place, such as Competent Authority proceedings or Advance Pricing Agreements still in force; and any comparable transactions or comparable companies identified during prior benchmarking exercises.

For all of the reasons above, arm's length transfer pricing has become a key input in all three M&A transaction stages. Corporations that wait until after the transaction has closed to address transfer pricing do so at the risk of sub-optimizing the risk management, cash flow and funding aspects of the combined enterprise. Our experience with clients over the years has demonstrated that integrating transfer pricing with M&A should happen during each of the three stages of the M&A process.

While the lists below are not exhaustive, they provide an idea of the transfer pricing activities that can and should take place during each stage. These activities can be carried out by external advisors and in-house transfer pricing specialists. Ideally, in-house professionals and advisors from each of the merging / combining companies will be able to exchange relevant information during the M&A process so that the joint efforts of the teams will yield early and useful planning results.

- *Planning / Due Diligence Stage:*
    - Review legacy transfer pricing policies and tax audit experiences of each of the legacy enterprises
    - Review existing intercompany transaction agreements with affiliated companies
    - Review legacy Advance Pricing Agreements or Competent Authority appeals
    - Review third party and internal "comparables" and benchmarks adopted by each legacy enterprise

- Review operating and cash flow projections for the combined enterprise to evaluate the application of the arm's length principle to such projections
- Review debt covenants for the combined enterprise that may be affected by transfer pricing
- Prepare a due diligence transfer pricing report incorporating conclusions and recommendations from the above review steps

- *Transaction Stage:*
    - Appraise tangible or intangible assets as required under the transaction
    - Review projected changes to combined business operations, including head office functions; supply chain, procurement, manufacturing and distribution; shared services, R&D and IP ownership and deployment processes
    - Prepare recommendations with respect to the application of transfer pricing policies and principles to contemplated operational changes
    - Anticipate the potential effects of transfer pricing on the anticipated debt covenants and cash flows of the combined enterprise, and advise the deal team of any concerns
    - Formulate a recommended global transfer pricing strategy for the combined enterprise

- *Post-Acquisition (Integration) Stage:*
    - Design a detailed transfer pricing structure that enhances free cash flow and shareholder value of the combined entity
    - Provide transfer pricing assistance in restructuring business operations, including head office functions; supply chain, procurement, manufacturing and distribution; shared services, R&D and IP ownership and deployment processes
    - Assist with the operational implementation of transfer pricing policies, including General Ledger reporting, budgeting / financial planning and management reporting integration
    - Assist with the evaluation and quantification of ASC 740-10 (Uncertain Tax Position) reserves relating to transfer pricing for the combined enterprise
    - Support counsel or the law department in the preparation of intercompany transaction agreements with affiliates
    - Provide support in securing or amending Advance Pricing Agreements
    - Prepare transfer pricing documentation for intercompany transactions

Because corporations are widening the global scope of their operations and supply chains, while tax authorities around the world attempt to claim their "fair share" of taxable income, corporations are at increasing risk of transfer pricing controversy, double taxation and non-deductible penalties. These risks are multiplied when two different legacy companies are combined into a new enterprise. At the same time, M&A transactions provide the opportunity to integrate the legacy transfer pricing policies of the acquirer and the target, to create a new, consistent transfer pricing policy for the combined enterprise, and to maximize after-tax free cash flows and shareholder value. This requires the expertise of a team of transfer pricing specialists who focus on understanding and applying the new company's strategic goals to the transfer pricing aspects of the combined enterprise.

By following the guidelines outlined in this article in a proactive process that proceeds in parallel with the stages of the M&A transaction, future transfer pricing risks can be minimized and planning opportunities can be identified and implemented in a timely fashion.

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